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BEFORE THE
DEPARTMENT OF TRANSPORTATION
WASHINGTON, D.C.

COMPUTER RESERVATIONS SYSTEM (CRS) REGULATIONS; STATEMENTS OF GENERAL POLICY	)	Docket OST-97-2881-387
	)	Docket OST-97-3014-139
	)	Docket OST-98-4775-188
Notice of Proposed Rulemaking	)	Docket OST-99-5888-64

COMMENTS OF ORBITZ, INC.

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Dated: March 17, 2003

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Dated: March 17, 2003

COMMENTS OF ORBITZ, INC.

Orbitz, Inc. ("Orbitz") respectfully submits these comments in response to the Department's November 15, 2002 Notice of Proposed Rulemaking (67 Fed. Reg. 69366).

Orbitz supports the policy initiatives in the NPRM. The CRS marketplace must be subjected to additional competitive forces as quickly as possible, for the benefit of all parties. Orbitz believes that this can be accomplished by the means of changes to the existing Part 255. Orbitz also believes that if such changes were adopted, it would be possible to sunset Part 255 as soon as three years from the effective date of the changes. Specifically, Orbitz proposes:

1. The repeal of the mandatory participation rule.
2. The continuation of the anti-parity rule and the application of the anti-parity rule and the newly proposed anti-tying rule equally with respect to all airlines.
3. The application of Part 255 to each CRS, whether or not it is owned by an airline or airlines.

4. Enabling more freedom of choice for travel agencies by limiting productivity pricing (and allowing agencies to renegotiate their contracts to provide for other means of compensation); limiting contracts to shorter terms (with no "shingling" allowed); limiting liquidated damages to the cost of physically removing a system; and allowing third-party software to be used on all equipment, whether or not it is owned by the agency.

5. The sunset of Part 255 three years after the effective date of these changes, unless it has been demonstrated to the satisfaction of the Department that competition does not exist in the CRS marketplace.

INTRODUCTION

The CRS rules originally were adopted because of the clear absence of competitive alternatives to discipline CRS behavior. The rules therefore were intended to limit the abuse of the market power of the CRSs. That market power manifested itself in a number of ways:

- Biased displays and the selling of bias to those airlines willing and able to pay enough (then referred to as "cohosts").
- Excessive booking fees imposed by the CRSs on airlines, especially competitors of the CRS owner, for the privilege of selling through the CRS.
- Imposition of contract terms on agencies designed to prevent agencies from having the effective choice of using other systems.

In some respects, such as by limiting display bias, the CRS rules have been relatively successful over the past eighteen years. In others, such as travel agency contracts, a well-intentioned attempt was made, but the CRSs largely found ways to defeat the intent of the rules. And with respect to booking fees, the rules have utterly failed to discipline CRS behavior.

As the rules have been amended and as circumstances have changed, we have reached a point where some of their provisions, most notably the mandatory participation rule (14 C.F.R. § 255.7), exacerbate instead of solve the CRS market power problem, and protect instead of limit CRS market power. We are at the point today where Part 255, though it contains some positive provisions, on balance better serves the monopolist than it serves the interests of competition, consumers, suppliers, and agencies.

It speaks volumes that in recent months the most vocal defenders of perpetuating the existing CRS rules for as long as possible have been the two largest CRSs. Clearly these rules, as they exist today, no longer serve, on balance, the pro-competitive purposes that they were intended to serve.

That does not mean that the best solution is no CRS regulation at all – at least, not yet. A market regulated by competition is always preferable to one shaped instead by government economic regulation. However, in this case, the largest CRSs still hold significant market power. Competition, unfortunately, would not discipline this marketplace if Part 255 were to sunset in the near future.

What is needed is a transition period in which we have CRS rules that, unlike the current rules, effectively promote competition. Making it possible for the marketplace to become a competitive environment, so long stymied by the dominance of a few players, would be the most effective means by which to introduce competition into the CRS marketplace, which would be the basis for ending economic regulation of CRSs at the earliest possible time.[1]

[1] The NPRM identifies Orbitz as being among parties that believe that the CRS rules are no longer necessary. See 67 Fed. Reg. at 69367. Orbitz never has taken that position, either in its filings in this docket, or in its presentation to the OMB. In the latter, Orbitz argued two points: that the mandatory participation rule should be repealed, and that the CRS rules should not be extended to the Internet. Orbitz did state that the current CRS rules have been, on balance, more anti-competitive in their effect than pro-competitive, but never has urged that immediate termination of the rules would be the best possible solution.

The existing Part 255 is, in large part, designed to make tolerable the fact that CRSs have market power. The rules mostly are oriented towards limiting the abuses of CRSs with market power. That may have been an appropriate approach when there was no technological alternative to CRSs, and virtually no prospect of competitive entry. However, in recent years there has come into existence a dynamic world of alternative technologies in the form of the Internet, microprocessor computing, and highly efficient programming languages. It is likely that more would become apparent with the prospect of lower barriers to entry. These developments mean that competition now could be introduced into the CRS marketplace, if only the old barriers to entry – and the regulatory assumption that those barriers would always exist – could be set aside.

We long have been in a period in which new competition was not possible in the CRS marketplace. Part 255 accepted that fact and attempted to make it tolerable. We now need a period in which we have rules that recognize that new competition is possible, and that are oriented towards allowing that new competition to develop.

New forces in the distribution of air transportation, mainly from the Internet, offer the promise of effective competition in future years in the CRS marketplace. Unfortunately, those new forces so far have been blocked by commercial and regulatory barriers from providing the direct competition that would effectively subject the largest CRSs to the competition that is the norm in other markets. The industry needs rules that encourage, rather than discourage, the coming of the day when competition disciplines the CRS marketplace. The industry needs rules that will make that day arrive as soon as possible. And when that day arrives, sunsetting the CRS rules entirely will be the appropriate course of action.

The Department should adopt rules with significant differences from the existing rules – rules designed to speed a transition to the day when there is sufficient competition in the CRS marketplace to end Part 255 entirely. The Department should adopt rules designed not so much to make it possible to live with a lack of competition, as to make it possible to introduce competition into the CRS marketplace

In sum, we long have had rules intended to enable us to survive by treading water. Now we need rules designed to get us out of the swamp once and for all.

I. THERE ARE IMPORTANT LESSONS TO BE LEARNED FROM THE COMPETITION IN THE ONLINE AGENCY MARKETPLACE AND THE LACK OF COMPETITION IN THE CRS MARKETPLACE.

A. <u>The CRS Industry – A Marketplace without Effective Competition</u>

The core of the CRS problem always has been, and continues to be, the following set of facts: each CRS has a large number of travel agencies using its system either as their exclusive channel for making air transportation bookings, or nearly so; nearly all airlines sell a high proportion of their tickets through travel agencies; airlines are a narrow-margin business in normal times (and a worse than narrow-margin business at present); and virtually no airline has credible competitive alternatives to participating in any CRS that refuses to offer the airline reasonable terms for its business, because the airline cannot afford not to sell through the large number of agencies that use that system. Airlines thus have no choice but to distribute through each CRS. Each CRS thus has the power to impose terms and conditions on airlines.

This fundamental problem is compounded by: how CRSs typically have made it close to impossible for any agency that uses its system to use any other or to switch systems entirely; the fact that the CRS business is highly concentrated (more concentrated today than it was when Part 255 was first promulgated);[2] and the fact that barriers to entry in the CRS business remain prohibitively high.

No CRS need compete for airline participation. Each airline must participate in each CRS, and each CRS therefore can dictate the terms and fees for that participation.[3] Each CRS has made itself the sole practical to way to sell through enough agents that each airline cannot afford not to sell through each CRS and not to reach the agents each CRS has under contract. Because both CRSs and airlines know that statement to be true, the CRSs can dictate to the airlines. They have done so for two decades, and they continue to do so today.

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[2] Based on the number of U.S. agency locations for each CRS, as stated in the NPRM, the market shares for each CRS are: Sabre 36.3%; Galileo 28.7%; Worldspan 20.1%; and Amadeus 14.9%. See id. at 69369. By this data, the HHI for the CRS industry would be 2,767. As noted on the same page of the NPRM, however, when measured as share of all CRS bookings at travel agent locations in North America, Sabre's share jumps to 48%. In that case, the HHI for this industry jumps to more than 3,200. By any measure, the CRS industry is highly concentrated.

[3] As with any general rule, no matter how valid, there are a few exceptions. Southwest is the most significant. It has built a very different method of distribution over more than two decades. Southwest is not now and never has been significantly dependent on CRSs, which has been a key part of its success. While most airlines sell about three-quarters of their tickets (by revenue) through CRSs, Southwest sells only about 20% through travel agencies. See Southwest Airlines Co., Form 10-K, at 16 (Dec. 31, 2002). And many of the tickets that Southwest sells through travel agencies are not sold through a CRS, since it only participates in one, so Southwest's actual dependence on CRSs is less than 20%. Moreover, while most airlines sell fewer than 10% of their tickets through their own websites, Southwest sells 49%. See id. at 4. Southwest also has conditioned its customers to purchase a very large percentage of its tickets through its call centers. In addition, even those tickets Southwest does sell through the CRS in which it participates (Sabre), it does not pay the normal booking fees that other airlines pay. Through a long-ago scheme that involved placing Braniff's discarded internal reservation system alongside Sabre, Southwest has been able to assert that it is not participating in Sabre at the same level as any other airlines, and receive a unique schedule of fees from Sabre. In other words, Southwest has for many years effectively voided for itself alone the anti-discrimination rule on CRS booking fees. If most other airlines magically found themselves with Southwest's distribution system, or could rapidly transition to it, there would be no CRS market power problem. They haven't, they can't, and there still is.

A few other airlines have managed to build from the outset distribution methods which also have a low reliance on CRSs, most notably JetBlue and AirTran, but no airline can duplicate Southwest's scheme for avoiding full CRS booking fees. Moreover, most airlines, including most non-major/non-network airlines, have a high degree of dependence on the CRSs. An airline with a high degree of dependence on CRSs cannot quickly shift to a low degree of dependence on CRSs, and therefore cannot easily obtain any negotiating leverage with the CRSs. Among network carriers, Delta has been perhaps the most aggressive about reducing its dependence on CRSs, yet Delta still derives 64% of its revenues from traditional travel agencies using CRSs. Delta derives an even higher percentage of its revenue from CRSs once sales made by online agencies through CRSs are counted. See 67 Fed. Reg. at 69378.

Not only has the CRS market power problem not diminished, but in at least one respect it is worse than ever. The airlines' financial performance – even in normal times a narrow margin proposition – is now in a third straight year of disaster. U.S. airlines had their worst ever (at that time) financial performance in 2001, and then did even worse in 2002. It is expected that 2003 will comprise, with the previous two, the three worst years in airline history. Airlines have less ability than ever before to withstand a loss of revenue for even very short periods of time in order to establish competition for the distribution of their air transportation services.

We know what a competitive distribution marketplace looks like. Both distributor and supplier want to reach an agreement in such a market – the distributor to increase its volume, the supplier to get its product on more shelves. The distributor wants the price for its service to be higher, the supplier wants the price to be lower. But both have an interest in closing a deal, and therefore an interest in negotiating toward mutually acceptable terms somewhere in the middle. Further, in a competitive market, both parties have the leverage of relying more on alternative service providers or vendors if acceptable terms cannot be negotiated. In short, both parties have an incentive to close a deal, and both have the ability to walk away if a reasonable deal cannot be negotiated. That is what drives both to make a deal at a reasonable balance point somewhere in the middle.

Indeed, a hallmark of a competitive marketplace for the distribution of a good or service is not that suppliers necessarily walk away from distributors, but that suppliers and distributors in fact negotiate terms and costs of distribution. And they can do that only if both parties have the ability to buy, or sell, the service elsewhere, and of not accepting a deal if satisfactory terms cannot be worked out. Another sign of a competitive marketplace is that a distributor lowers its costs to suppliers in return for the right to distribute more of their product, and by having more product to sell, the distributor attracts significantly more volume to its business. Neither of these characteristics of competition ever has existed in the CRS marketplace.

In theory, at least, both the airline and the CRS have incentives to reach a deal. But the airline cannot turn to another vendor who will competitively display the airline's services on the desktops of the agencies that are under contract to the recalcitrant CRS. An airline therefore cannot walk away from an unreasonable deal, and both the airline and the CRS know it. Each CRS has the airline over a barrel. The CRS can – and does – dictate terms.

This is the basic fact on which the Department of Justice and the Civil Aeronautics Board rested the case for the market power of the CRSs, and the case for rules intended to limit the abuse of that power, nearly twenty years ago. As the CAB stated:

> All of the indicia of market power in traditional economic terms are exemplified by the undisputed facts in this rulemaking.... [V]irtually all carriers must have access to a large proportion of travel agents in the regions the airlines serve. Reaching 90% of the travel agent market efficiently requires access to CRS systems. In economic terms, the cross-elasticities of demand between CRSs and their alternatives are very low for almost all airlines and travel agent.

Computer Reservations Systems, Notice of Proposed Rulemaking, 49 Fed. Reg. 11644, at 11654 (March 27, 1984).

Stating the same thing in non-economic terms, Dan May, CEO of Republic Airlines, testified to the Senate Commerce Committee in 1985:

> The ability of the big CRS owners to injure competitors stems from the fact that, as a general rule, if you want to be in the airline business, you have to sell seats through Sabre or Apollo [as Galileo was then known].... There are no contract negotiations. It's take it or leave it. In Republic's case, we would not have lasted more than 30 days without bookings on Sabre and Apollo, so we took it – despite the huge fee increases that were entailed.

Hearing Before the Subcommittee on Aviation of the Committee on Commerce, Science, and Transportation of the U.S. Senate on Computer Reservation Systems, Senate Hearing 99-38, at 29-30 (March 19, 1985). That statement unfortunately remains accurate today.

No CRS has a reason to cut its fees, since cutting the cost of distribution is not expected to gain it any additional market share. Market share is driven solely by the number of agencies under contract to the CRS, and most agencies under contract to a CRS have little or no latitude to book on any system other than their primary CRS.

The problems Part 255 originally set out to fix all were problems growing out of the fact that each CRS had a nearly unbreakable grip on a significant number of travel agencies, and could therefore dictate terms to the purchasers of CRS services – i.e., the airlines:

- Display bias was a problem because there was no market restraint on it. Airlines that were harmed by bias did not have a credible option of using an alternative system if the bias was not diminished. Nor did agencies abused by bias (in that bias made it harder for them to serve their customers) have a credible option of using or switching to another system.

- Booking fees were excessive because virtually no airline had a credible option of using an alternative system in order to gain leverage to negotiate for lower fees. With few exceptions, airlines did not have the option of using a competitive alternative to reach the agencies that each CRS had under contract, whatever the fees charged by that CRS.

- Most agencies, once they initially selected a system in the 1970s or early 1980s, found themselves in a relationship from which they could not escape. Therefore, they could not reject new contract terms that often were even more restrictive of their ability to choose, or use, another system. Once in, it was increasingly difficult to get out.

Part 255 originally was intended to limit each of these abuses of market power by the CRSs. Over the years, the rules were sometimes relatively successful in limiting a form of abuse (i.e., display bias), sometimes were only slightly so (i.e., travel agency contracts), and sometimes were not at all successful (i.e., CRS booking fees). But in no case did Part 255 undo the underlying market power of the CRSs. That power is still there, to this day.

The calculus underlying the airlines' inability to walk away from a bad CRS deal, and therefore to have a real opportunity to negotiate a better one, is as inexorable today as ever. If Sabre sells 48% of all the tickets that are sold through a CRS in North America by revenue, and if the typical large airline sells more than 70% of its tickets through travel agencies using a CRS (see 67 Fed. Reg. at 69369, 69378, 69380), then the typical airline relies on Sabre-dependent agencies, and therefore on Sabre, for over a third of all its passenger revenues. The airline could not last even a few days without that stream of revenue. Sabre's power to threaten to remove an airline that does not meet its terms of participation is therefore absolute – it can and does dictate terms. It need not negotiate with any airline.[4]

[4] It could be argued that if an airline declined to participate in a CRS, not only would the airline lose the revenues from its sales through the CRS, but the CRS also would lose the revenues from its sales on that airline, creating for both parties sufficient incentive to negotiate. But this clearly has not produced negotiations in practice. One reason is that the CRS typically relies on the airline's sales less than the airline relies on its sales through the CRS. It is typical for an airline to obtain between 10% and 40% of its revenues through any particular CRS, but it is typical for a CRS to obtain between 0% and 25% of its revenues from any particular airline. Furthermore, while the CRS business is highly lucrative, and CRSs could withstand the non-participation of one airline for a long period of time, an airline, as part of a narrow-margin business, could not withstand the loss of significant revenues for very long. Finally, because agencies are so tightly bound to the CRS that has them under contract, agencies cannot easily switch away from a CRS that is not competing for and obtaining full airline participation. A CRS would suffer no significant near-term loss of agent participation by virtue of an airline declining to participate in that CRS. Thus, if an airline were not to participate in a CRS, the harm would be felt almost entirely by the airline, and not by the CRS. There is no question as to which of the two could bear its pain longer. Hence, the airline has no leverage, and there are no competitive negotiations by CRSs for airline participation.

Even in the case of a CRS with only half of the sales of Sabre, that CRS would still control access to agencies selling about 17% of all of the passenger revenues of the typical airline. The result functionally would be the same – no airline could credibly claim that it had the option of using a competitive alternative to reach agents and/or consumers representing more than 17% of its passenger revenues, nor could it afford to lose 17% of its passenger revenues. From an airline's perspective, each CRS is the sole means of access to nearly 100% of the agencies that CRS has under contract, and to nearly 100% of the consumers who use those agencies. The number of agencies, and the consumer demand they represent, is sufficiently large as to be irreplaceable – the airline cannot reach them by alternative means and cannot live without them. As a result, no CRS is under any competitive pressure to offer significant discounts to get greater participation by one or more airlines. Each airline has to participate in each CRS.

The Department correctly has characterized the CRS market power problem, and has correctly concluded that it continues today. The Department accurately concludes in the NPRM:

> Despite important changes in the industry, there is evidence that each of the [CRS] systems continues to have market power against most airlines that could be used to distort airline competition and competition in the business of electronically providing airline information and booking capabilities to travel agents.... We are additionally concerned about system practices that seem unreasonably to keep airlines and travel agents from using alternatives to the systems. (67 Fed. Reg. at 69368.)
>
> The systems have been able to maintain high booking fees, because most airlines have concluded that participation in each system is necessary. (67 Fed. Reg. at 69370.)
>
> [W]hile the roles of the travel agents and the systems in airline distribution gave each of the systems market power, the systems also engaged in practices that buttressed their market power by reducing the ability of airlines and travel agencies to use alternative electronic means for the task of communicating information and making bookings. (67 Fed. Reg. at 69376.)

> [T]he developments in airline distribution [i.e., the Internet] may not have eroded the systems' market power as to airlines: travel agents sell most airline tickets, travel agents usually use a system to investigate airline service options and to make bookings, and each travel agency office relies entirely or predominantly on one system.... Our tentative belief [is] that the systems continue to have market power.... (67 Fed. Reg. at 69377.)
>
> [A]n airline's withdrawal from one system would likely substantially reduce its bookings from travel agents using that system. As a result, airlines have not had significant bargaining leverage against the systems, because the systems have not needed to compete for airline participants. (67 Fed. Reg. at 69380.)
>
> We believe that the systems can engage in such practices [reducing competition or giving biased or inaccurate information about airline services to consumers and agents] because each system still seems to have market power over the airlines. Market forces therefore have not disciplined the price and terms of services offered airlines by the systems. In particular, the systems appear to be charging booking fees that seem to exceed the fees that would be charged in a competitive industry. (67 Fed. Reg. at 69385.)

The reality in the CRS marketplace is bluntly clear. As recently stated in the New York Times:

> "We sell over $5 billion a year through Sabre," said Craig Kreeger, vice president for sales at American. "If they increased the fee by 50 percent, I would probably have to pay it. I have absolutely no leverage."

Saul Hansell, "Even as the Big Airlines Struggle, Computer Booking System Prospers," N.Y. Times, at C1 (Feb. 10, 2003). If that is the hard reality for American Airlines, the world's largest airline, then it is the hard reality for any airline with a significant degree of dependence on CRSs. Whether it is Mr. Kreeger and American in 2003, or Mr. May and Republic in 1985, the inescapable fact is the same: there is no negotiation, not in the past, and not today – it is still take-it-or-leave-it.[5]

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[5] It cannot be argued that CRSs are prevented from negotiating with airlines by the provision of the CRS rules which prohibits fee discrimination by CRSs (14 C.F.R. § 255.6(a)). Any system, under the existing Part 255, can negotiate with any airline any deal it wishes, then make that same offer available to any other airline willing to accept its terms and conditions. In some instances this regulatory provision might inhibit a CRS from striking a particular deal with one airline that it was not willing to make available to all airlines, but it cannot reasonably be argued that the provision prevents all possible negotiations and all possible deals.

Prospect for change is limited and slow under the present regulatory regime. Sabre itself has forecast that the CRS share of all U.S. airline bookings will decline very little, from about 75% in the recent past (counting all CRS bookings, both by traditional agencies and online agencies) to about 65% in 2005. See 67 Fed. Reg. at 69374, 69378. That is certainly not enough to suggest the presence of the viable non-CRS distribution alternatives that would be necessary for a competitive CRS marketplace. Sabre's forecast presumably is based on the continuation of today's rules, or some set of regulations equally ineffective at promoting competition. If we had CRS rules that effectively encouraged competition, change would, of course, would occur more rapidly.

In some respects the leverage imbalance, and therefore the market power problem, is worse than ever. Without the unimpeded availability of non-CRS alternatives, with CRSs enjoying very high profitability, and with airlines suffering through their worst financial morass in their history, airlines have no viable options, and less ability to simply "hold-out," while the CRSs have more ability to weather a test of wills than ever before. In 2002, U.S. airlines had a collective operating margin of negative 10%, according to the Air Transport Association. Sabre, in contrast, had an operating margin of positive 20.4% in that same year, despite the disastrous results in most segments of the travel industry. See "Sabre Holdings Reports Financial Results for Fourth Quarter, Full Year 2002," Press Release (Jan. 16, 2003). There is no question that Sabre could endure non-participation by any CRS-dependent airline far longer than the airline could survive. Both parties know that, and behave accordingly.

B. Online Travel Agencies – A Marketplace with Vigorous Competition

The online agency business has been transformed in recent years into an automated distribution marketplace that is effectively disciplined by real competition – exactly what needs to occur in the CRS marketplace, so that Part 255 can be replaced by effective competition. By examining the transformation of the onlien business, we can better understand what has to change in the CRS business for that goal to be achieved.

In its early years, the online agency industry showed only modest pro-competitive promise. The key positive difference from the CRS model was that the user of an online travel agency (i.e., the consumer) was, unlike the user of a CRS (i.e., the agency), not bound by any contract, and was therefore free to switch at the click of a mouse to any other website. Online agencies (most notably Travelocity and Expedia) did bias their systems, not because they were owned by airlines, but because they could sell that bias to airlines. Nevertheless, the degree of that bias was somewhat limited by the fact that if a website did not meet the needs of its users, it would soon lose some of those consumers, since they were not bound to that outlet.

However, in other respects online agencies in the early years of the Internet served the CRS oligopoly, rather than competed against it. Initially, online agencies all used CRSs to process their bookings and gave no discounts to airlines to offset the standard CRS booking fees, which left those excessive costs to be passed on to airlines and ultimately to passengers, as they always had been. In that respect, online agencies initially were little more than CRSs modified for direct consumer use, and they retained the CRS business model of high fees dictated by the distributor. They were, in effect, branch offices for CRSs on the Internet.

Travelocity was launched by Sabre in 1996, and Expedia shortly thereafter, along with individual airline websites, other online agencies, and, ultimately, webfares. But none of these developments materially changed the CRS-like business model of the online agency industry.

What changed the online agency world into a more competitive marketplace was a combination of factors: the airlines' recognition that each could use access to limited discount inventory as an incentive for distribution channels to lower their costs, and the decision of at least one new entrant, Orbitz, to offer (however indirectly) lower booking fees to airlines in return for those airlines allowing Orbitz to sell all of their publicly available webfares. It was a simple option offered to all airlines – in return for more of the airline's distribution business the distributor offered to lower the airline's costs on all of its transactions. Orbitz made the offer on a strictly voluntary basis (an airline could continue to pay the typical CRS booking costs and not sell its webfares on Orbitz – and still receive unbiased display on Orbitz – or it could pay, on average, about 30% less in CRS fees for all bookings made through Orbitz and offer its webfares on Orbitz), as well as on a strictly non-exclusive basis (if an airline decided to offer its webfares on Orbitz, it retained total freedom of choice to decide to sell or not sell those same fares through any other outlet).

This new concept of linking access to webfares to a substantial reduction in the cost of distribution gave airlines participating in Orbitz the first real leverage that they ever had in the automated distribution marketplace. That linkage was the most pro-competitive development that has occurred in the history of that marketplace. Previously all leverage had been firmly in the hands of the distributors, the CRSs. Now the airlines had a small amount of it.

Before Orbitz, so long as no agency sold webfares, there was no leverage to be gained from access to webfares. The online agencies in particular were under no competitive pressure to get webfares and were not particularly interested in offering them. At a time when only individual airline websites offered webfares, online agencies did not perceive any need to bargain to get those webfares. When Orbitz launched in June 2001, Travelocity and Expedia for the first time faced a direct competitor that had lowered its booking costs to obtain webfares, and was in direct competition with them. They immediately felt the competitive pressure – a new entity was competing for the same consumers, had broken the mold of their business model, and had webfares that they did not offer.

The normal competitive response would have been to enter into their own deals with the airlines, likewise offering the airlines lower booking costs in return for access to their webfares. Initially, they tried to avoid taking that pro-competitive step, by encouraging government to obstruct any new price competitor. But the government declined to be such a barrier to competition. After thorough review, the Department found no reason to intervene and gave Orbitz a green light to launch as planned. See Letter from Susan McDermott and Samuel Podberesky to Jeffrey G. Katz (April 13, 2001) (Appendix A).[6]

In early 2002, after Orbitz had been in business for about eight months, Expedia and Travelocity finally adopted the appropriate competitive response – i.e., they began entering into deals with airlines to reduce the airlines' booking costs in return for access to webfares. Each agency adopted a slightly different approach in their negotiations, but the end result was that they each dealt for and received significant access to webfares.

It is important to understand why they shifted to a strategy of competing, rather than preventing competition, because that is the same change that needs to happen in the CRS

[6] After further review, both the Department (in its June 27, 2002 Report to Congress) and the Department Inspector General (in his December 13, 2002 Comments on the report) found Orbitz unobjectionable and in some respects pro-competitive in its effects. See Appendices B-C.

industry. Expedia and Travelocity concluded they could no longer refuse to negotiate with airlines to obtain webfares, because Orbitz – though smaller than them (representing about 30% of the market share of the three largest online agencies) – offered webfares. Orbitz had obtained access to webfares by offering sufficient discounts in the cost of making a booking to induce forty-two airlines to voluntarily agree to make those webfares available in return. A new competitor with significant market share, and the webfares of most airlines, was what it took to change the behavior of the two dominant online distributors in a pro-competitive direction.

In early 2002, Expedia and Travelocity negotiated wide-ranging deals with individual airlines to obtain webfares in return for reductions in the cost of bookings through their sites. By spring 2002, they were advertising widely that they offered webfares, as indeed they did. But they had to engage in price competition for the first time in order to obtain them. Normal competitive behavior had finally been introduced into the online agency market. Both the online agencies and the airlines had some negotiating leverage, and an interest in reaching a deal for wider distribution of more product. In that environment, price discounting occurred, and deals were negotiated, as they would be in any competitive marketplace.[7]

As this pro-competitive transformation was happening in the online agency marketplace, the various parties in that marketplace had to adjust to the new reality. Those adjustments sometimes took time and trial-and-error. For example, in March 2001, Northwest tried and failed to negotiate new agreements with Expedia and Travelocity with respect to the cost of

[7] The Expedia and Travelocity deals struck with the airlines in early 2002 did not exactly mirror Orbitz's deal with the airlines, since Expedia and Travelocity also had bias/preferred carrier deals by which they committed to swing specified amounts of market share to a particular airline in a particular city pair, in return for a specified override commission or other form of compensation. Expedia and Travelocity's deals thus often have to take such market-by-market issues into account, whereas Orbitz's deals do not, since Orbitz is contractually committed to not bias its displays or enter into preferred carrier arrangements, to not swing traffic, and to not collect override commissions or other forms of compensation to swing specified amounts of traffic.

bookings and the quality of service. Northwest, in frustration, decided not to pay them the then standard online agency commission. Expedia then negotiated a new agreement with Northwest, but Travelocity refused to do so. The impasse between Travelocity and Northwest continued for months. It was not clear at that time whether leverage still was entirely in the hands of the distributor, as in the CRS model, or had become more balanced, as in the pro-competitive model. By early 2002, with the online industry moving rapidly in the pro-competitive direction because of Expedia and Travelocity's competitive responses to Orbitz, it had become clear that the leverage was now more evenly balanced. Reflecting those changed circumstances, in February 2002 Travelocity and Northwest quickly resolved their differences. The terms of their new agreement were never made public, but it was widely understood in the industry that the agreement involved reduced booking costs for Northwest. A similar dispute later in 2002 between Northwest and Expedia similarly was settled in three weeks.[8]

In sum, this was a period in which the participants in the online agency marketplace – even though many of them were accustomed to dealing with the very different dynamics of the CRS business – came to understand that online agencies had become a competitive marketplace. Airlines could decline to do business with an online agency if that agency would not offer reasonable terms; online agencies could decline to do business with an airline if that airline would not offer reasonable terms. Both airlines and online agencies realized that they had every incentive to reach an agreement, and would be better off if they did so.

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[8] See generally "Travelocity Fires Back, Adds Fees on NW/KLM Tickets," Aviation Daily, at 3 (March 2, 2001); "Travelocity Drops Service Fee on NWA/KLM," Travel Weekly (Feb. 8, 2002); "Northwest Fares No Longer On Expedia As Talks Break Down," Aviation Daily, at 1 (Oct. 2, 2002); Jim Hu, "Expedia and Northwest Make Up," News.com (Oct. 21, 2002) <http://news.com.com/2117-1017-962740. html>.

Out of that new understanding has come an online agency marketplace which is now characterized by negotiation between parties. It is animated by the understanding that Orbitz initially gained market share by being willing to be a significant discounter to airlines of the cost of distribution. The online agency marketplace has become highly competitive; and it produces new and real efficiencies in the cost of air transportation, efficiencies that ultimately are passed on to consumers. Behavior in the online agency marketplace is now disciplined by competition, so it need not be disciplined by a large construct of prescriptive economic regulation.

It is important to reflect on how we have moved from the early years of an online agency market – which in many ways was an outpost of the CRS market, and which certainly duplicated the non-competitive booking costs of the CRS market – to a marketplace that is fully competitive and highly price efficient. This experience shows what will have to change in the CRS industry for competition to be effective, and for CRS rules therefore to be unnecessary. There were three key ingredients that together made this transition to effective competition in the online agency industry possible:

- The user of the online agency (i.e., the consumer) was not tied in any way to that outlet. If a given website did not meet his or her needs, he or she could instantly try another site, and another site. Because users could readily switch, bias could not be extreme, because users would conclude they were adversely effected by it. Moreover, because users could readily switch, once a major online agency offered to reduced booking costs in return for webfares, the other major online agencies had to become price competitive in what they charged airlines, in order to obtain the webfares they needed to be attractive to users who otherwise could and would switch.

- When Orbitz launched in June 2001, a linkage was established for the first time between the cost of distribution and access to webfares. For the first time, a major automated distributor of air transportation was attempting to gain market share among consumers by lowering the distribution costs for airlines. The linkage to webfares was the pro-competitive key. Lower booking costs led to increased market share for Orbitz because the lower fees motivated forty-two airlines to grant Orbitz access to webfares, and because Internet users could readily switch to a distributor offering a wider selection of attractive fares. That new linkage of lower booking cost to access to webfares, and thus the ability to attract additional users, is what gave individual airlines what they never had in the CRS marketplace – some competitive leverage with which to obtain negotiations over the cost of bookings.

- The degree of airline dependence on each of the three major online agencies was low enough (typically about 2% of all passenger revenues) that an airline had credible competitive alternatives to each online agency if a satisfactory agreement could not be reached. Likewise, the agency could credibly opt not to distribute an airline's seats if a satisfactory agreement could not be reached. Neither party could dictate terms to the other.

Out of this new reality – the ability of users to readily switch, the leverage of the webfares-and-lower-booking-costs linkage and the resulting competition among multiple sales agents for airline participation, as well as competitive choice among roughly equal alternative distribution channels – a competitive marketplace has been established with negotiated terms and conditions, and significant price discounting. The result is that more webfares are available through more outlets than ever before, and the cost efficiencies of the Internet have helped lower the airlines' basic cost of air transportation, to the ultimate benefit of the passenger. In fact, because the entry of Orbitz represented not only new price competition, but also new competition in the quality of search technology, consumers of online agency services now have better information available to them than ever before. Because of Orbitz and a competitive online agency marketplace, consumers are closer than ever to a world of perfect transparency of competitive offerings in air transportation.

In short, services have improved and prices have decreased – just what one would expect real competition to accomplish. The key issue in this rulemaking is how to make it possible for that also to happen in the CRS marketplace.

C. The Online Agency Model Can Bring Competition to the CRS Marketplace, Given the Right Regulatory Decisions.

The central questions in this case are:

- Whether the pro-competitive transformation that has occurred in the online agency market can be replicated in the CRS marketplace.
- If not now, when can that be expected to happen?
- What kind of rules would hasten the day when the CRS marketplace is as competitive as the online agency marketplace (i.e., when we can cease to rely on a complex overgrowth of economic regulation of CRSs and rely, instead on genuine and effective competition)?

The key ingredients that made possible the transformation of the online agency business into an effectively competitive marketplace are not present in the CRS industry:

- CRS users are not typically free to use other systems, or to switch systems entirely.

- No connection has been established between a CRS lowering airlines' booking fees and obtaining access to their webfares from a large number of airlines, and as a result that CRSs being able to attract new users. Therefore, no CRS has decided to be a significant price leader.

- The degree of dependence for most airlines on each CRS is very high, and as a result each CRS has the ability to dictate the price for their distribution services on each airline. There is no need to compete for airline participation.

Absent these essential ingredients for competition, CRSs continue to dictate terms to airlines. What has transpired in the neighboring online agency business has not changed this central feature of the CRS business. The CRSs dictate what levels of participation will exist, and what price will be charged for participation. No matter what happens to the underlying costs of automation, or the cost of telecommunications, or the ability of the airlines to pay, or the viability of the travel agencies who use the CRSs, or the consumer demand for air transportation (and thus the demand for CRS services), the price for CRS services goes up every year. In the CRS business, prices only go up – whether costs are up or down, and whether demand is up or down. That is the way it has been every year for nearly two decades. Every year, each CRS simply announces its latest price increase. There is no negotiation. There is no alternative. There is no need for any CRS to engage in discounting initiatives to get airline participation.

Recently, the question has been whether, with the three major online agencies now offering an extensive selection of webfares, CRSs would be under any pressure to negotiate booking fees and other terms attractive enough to get webfares from most airlines. This pressure thus far has been very limited and largely ineffective. The reasons for this include:

- The major online agencies together only account for about 6% of all air bookings by revenue.[9] In contrast, the CRSs recently accounted for about 75% (including most of the online agency bookings). Sabre forecasts that will only decline to 65% by 2005. See 67 Fed. Reg. at 69374, 69378. Each CRS represents far more bookings than any online agency does, and that is expected to remain true for many years. An airline may be able to negotiate with an online agency – it cannot with a CRS.

- The CRSs continue to use contract provisions that prevent agencies from practically booking significant amounts of tickets on non-CRS alternatives, even though those alternatives are technologically more available than ever to agencies.[10]

- Many consumers who use travel agencies are not inclined to become direct users of the Internet. Therefore, if the agency cannot switch to a non-CRS booking channel, the consumer cannot switch either. A large portion of the CRSs' volume is simply not threatened by online agencies with webfares, any more than it has been threatened for the past eight years by individual airline websites with webfares.

- CRSs looked first to ways to obtain webfares without having to lower their costs. For example, certain CRSs entered into deals with screen-scrapers, such as Farechase,

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[9] See 67 Fed. Reg. at 69376. According to PhoCusWright, 14% of all airline sales are made via the Internet, and 42% of those Internet sales are made by online agencies. Therefore, 6% of all airline sales are by online agencies. That percentage presumably has increased in the past year, but not by nearly enough to have deprived CRSs of their dominant position, their market power, and their ability to dictate to airlines – as their behavior continues to demonstrate.

[10] The ASTA Agency Automation Survey (2002) shows that even though agent access to the Internet is now very high, use of the Internet to make air bookings is low. The survey cites "GDS contracts" as one of the top "reasons for not booking online." See id. at 18.

through which they hoped to gain access to fare information without having to engage in any price competition in return.

First Sabre, and then Galileo, announced a new level of participation in their systems,[11] in which they would discount their booking fees by 10%, and freeze their fees for three years, if an airline agreed to allow them to sell all of that airline's webfares. This was not a negotiation, but another take-it-or-leave it proposition. Only US Airways, which already was in bankruptcy, took the offer. The offer was not a step toward competition, but an attempt to prevent competition. It required a three-year commitment by the airline, meaning that the airline would accept only a token reduction in the booking fee, in return for giving up any hope that real competition might arrive at any time in the next three years and generate substantial reductions in the booking fee.[12]

Significantly, the same airlines that have been prompt in negotiating webfares-for-lower-booking-cost deals with all three major online agencies have, for the most part, shown no interest in accepting the 10% proposition from Sabre and Galileo. For example, forty-one of the forty-two airlines that agreed to the original Orbitz webfares-for-lower-booking-costs deal have shown no interest.[13]

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[11] Sabre announced on October 21, 2002, and called its product "Direct Connect Availability Three Year Option." Galileo announced on October 25, 2002, and called its product "Preferred Fares." See, e.g., Dennis Schaal, "Galileo strikes Web-fare deal with US Airways," Travel Weekly (Nov. 7, 2002).

[12] The 10% CRS reduction offer is significantly less than "market" offer for the value of an airline's webfares. The original reduction offered to Orbitz participating carriers amounted to about a 30% reduction, and the more recent Orbitz Supplier Link reduction amounts to more than 60%.

[13] Galileo subsequently offered a further variation, called "Momentum." Galileo would offer essentially the same package, but with a 20% reduction in fees, applicable only to sales made through travel agencies that agreed to rebate to Galileo an amount essentially equal to the spread between 10% and 20% reductions. In other words, Galileo was willing to discount beyond 10% only if travel agencies agreed to assume the cost of the greater discount. Among airlines, only US Airways and United, both in bankruptcy, have agreed to participate. Subsequent trade press reports have down-played the significance of this offering, pointing out that few agencies other than those controlled by Galileo's parent company (i.e., Trip.com and Cheap Tickets) have agreed to participate. See "Galileo adds Momentum participants," Travel Weekly (Feb. 21, 2003).

With so few airlines accepting in Sabre and Galileo's offers, there is no pressure on other CRSs to match, or improve upon, the offer. Clearly, the other two CRSs have seen no loss of business to Sabre and Galileo as a result of the two largest CRSs offering the webfares of only one airline (or in the case of a very few agencies, two). This in part is because Sabre and Galileo have refused to lower their booking fees enough to obtain substantial participation by airlines, and in part because other CRSs see little prospect of losing market share to Sabre and Galileo – since CRS users are typically tied to one CRS, and cannot easily shift their business to a competing distribution system even if that system offers greater fare availability.

Thus, the competitive dynamic that raced through the online agency business in 2002 is going nowhere in the CRS business. In 2002, Travelocity and Expedia were compelled due to competitive pressure to negotiate costs-for-webfares. Today, the CRSs feel no such compulsion. They are doing just fine as is. There is no effective competitive pressure.

CRSs therefore continue to dictate listed levels of participation and the price of each. The airlines have no other choices nor any ability to negotiate or to obtain any recognition that both the supplier and the distributor need the other. The CRS business continues to be a market where the supplier would die without the distributor long before the distributor would die without the supplier. Both parties know that, and they behave accordingly.

No CRS feels the need or even that it is advisable to lower its booking fees enough to obtain widespread webfare commitments from airlines, as Orbitz did in the online agency marketplace. Why should it? If one CRS had webfares, would that CRS either gain market share or force other CRSs to do make similar deals? No, because a CRS's users – travel agencies – cannot readily switch. A CRS's market share is determined by the number of agencies it has under contract, and the extent to which those contracts keep those agents from using or switching to any other system. There is no reason to be a price leader in the CRS business.

The problem of airlines having no leverage with CRSs is now, in fact, worse than it has ever been, given the unprecedented financial situation of the airlines, and the fact that CRSs are continuing to make extraordinary profits, even in terrible times for most of the travel sector. No CRS is under any pressure to accept the Expedia/Travelocity mode of competition (i.e., to negotiate airline-by-airline webfare-for-lower-fees deals). Nor is any CRS under pressure to adopt the Orbitz mode of competition (i.e., to offer substantial reductions in booking fees sufficient to obtain webfares from a large number of airlines). In a business where users are tied to systems, the CRSs see little to gain in the way of expanded market share by expanding their offerings to their users.

There are certain critical facts that no longer require any speculation. We have two decades of experience with the CRS marketplace, in which the CRSs can and do dictate to the airlines, because the airlines have no choice but to acquiesce. We also now have over a year of experience with an online agency marketplace that has been transformed into a forum in where distributors and suppliers negotiate with each other, because they know neither can dictate to the other. Competition has been introduced into the online agency marketplace due to the willingness and ability of a new competitor to gain market share by reducing the price charged for distribution services. We can look at the characteristics of each marketplace and see what produces a competitive marketplace and what produces a marketplace characterized by unreasonable market power. The experiment is completed, and the results are in.

In the CRS marketplace, in the relationship between an airline and a CRS:

- The airline typically relies on that one CRS to provide somewhere between 10% and 40% of its passenger revenues.

- For most of those revenues, that CRS is the only way to sell through its agencies and reach their customers; i.e., travel agencies cannot readily switch systems or book by other means.

- No CRS faces a significant competitive threat from other CRSs offering large selections of webfares. Sabre and Galileo have the webfares of US Airways, which now accounts for only about 6% the supply of domestic airline seats.[14] CRS users have little likelihood, in any event, of switching their business to a CRS that does have webfares.

In the online agency marketplace, in the relationship between an airline and a major online agency:

- The airline typically relies on that one online agency to provide about 2% of its passenger revenues.

- For most of those revenues, the online agency is not the only way to reach that agency's customers. Online consumers typically shop and compare multiple sites. Thus, if an online agency does not carry an attractive fare, a significant number of that agency's customers will end up booking that fare through another site. If the user is up for grabs, the competitive imperative to obtain the most attractive fares is far more potent.

- The two established major online agencies faced a new third competitor that offered webfares from forty-two airlines.

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[14] As discussed *supra*, with respect to a few agencies, Galileo offers webfares from both United and US Airways, which together account for about 23% of domestic airline seats. <u>See, e.g.</u>, "US Industry Traffic Market Share," <u>Aviation Daily</u>, at 7 (Jan. 21, 2003).

We know from real-world experience that the CRS marketplace leaves the distributor in a position to dictate; leaves the airline no ability to insist on negotiation; leaves distributors with no reason to be meaningful price leaders; and has produced the inefficiencies of market power, including excessive costs and a need for elaborate economic regulation to prevent even worse abuses of market power. We know that the online agency marketplace leaves neither the distributor nor the airline in a position to dictate; strongly encourages both to negotiate; allows a distributor to can gain market share by being a price leader; and in the end produces the efficiencies of a competitive market.

What we do not know is where between the first situation and the second we could reasonably expect negotiation, price competition, and competitive efficiencies to begin to occur. If alternative distribution channels were developed, and switching costs and other barriers to travel agencies' choice of booking tools were minimized, the total airline reliance on CRSs likely would be reduced – in particular their reliance on the most dominant CRSs. Under those circumstances, airlines might be in a position to insist on negotiation. For example, if instead of 70-75% of all airline passenger revenues being booked through today's CRSs, no more than 40% were, with much of the remainder moving through new CRS entrants, direct sales via airline websites, or alternative distribution, and if the dominant CRS, instead of accounting for over 40% of all bookings by traditional agencies, accounted for no more than 20%, airlines then might obtain the ability to negotiate with CRSs. The key would be competitive alternatives – an airline's ability to effectively reach, through an alternative channel, a majority of the consumers otherwise lost if that airline's flights were no longer listed on a particular CRS; reaching them either because the agents using the CRS that had de-listed the airline switched to another CRS or used new, alternative search and booking capability, or because consumers bypassed the travel agency/CRS channel and bought directly from the airline or a website that still carried its flights.

But the fact is, we do not know the precise market share levels at which airlines would be able to insist on negotiation, or the point at which the CRSs would be under significant pressure to engage in price initiatives or not. We do not know how much less reliance each airline would need on CRSs in order to transform the CRS marketplace to a competitive one. Moreover, we do not know the extent to which technological innovation and regulatory requirements will make it practical for agencies to book on competing alternatives if the CRS they are contracted to does not lower its booking costs sufficiently to in return obtain the webfares of most airlines. It might be that if agencies could readily book on or switch to alternative systems, effective competition would exist with 50% of bookings still being routed through CRSs, but if agencies could not do so, effective competition would not exist even if only 40% of bookings were still made through CRSs. Under these circumstances, trying to select market share numbers at which a competitive marketplace would emerge would be mere speculation.

A better approach would be to judge the CRS business functionally. The Department will know that competition has arrived when the participants in the CRS marketplace behave as if they are in a competitive marketplace. It is clear from recent experience in the online agency marketplace what such behavior would look like. When a significant number of airlines are negotiating fare availability and participation on the part of the airline in return for booking costs and service quality on the part of a significant portion of the CRSs, and they are indeed reaching agreements, then the Department could say that competition had arrived in the CRS industry, and that CRS rules are no longer needed. Similarly, when a CRS adopts the strategy of lowering its booking costs enough to obtain webfares from many airlines, and then uses its access to those webfares to expand its market share, and either does prompt a significant increase in its market share or a similar competitive response from other CRSs in order to prevent that shift of market share, then the Department likewise could conclude that competition had arrived in the CRS industry, and that CRS rules are no longer needed.

Put another way, when airlines and distributors behave toward each other in the CRS marketplace as they do today in the online agency marketplace today, then the Department can conclude that competition is at work and can be relied on in that marketplace.

Until that day, the most important task for the Department is to modify the existing CRS rules so as to hasten new entry, the development of technological alternatives and of choice by users as to which alternative to use, and the day when the CRS marketplace is competitive and when Part 255 can sunset. The Department specifically should set out to create CRS rules that will serve as the swiftest and surest possible means to transition to a CRS marketplace genuinely disciplined by competition, not by economic regulation. The Department has defined its goal correctly:

> Our goal is to facilitate the development of alternatives to the systems for both travel agencies and airlines and thereby reduce the systems' market power and potentially reduce or eliminate the need to regulate them.

67 Fed. Reg. at 69389-90. Orbitz agrees with this goal, and would only add that the Department should seek to accomplish it as soon as possible.

That goal is the opposite of the situation today under the existing CRS rules.

- Airlines should have sufficient leverage to insist on negotiation, rather than be dictated to by CRSs. But there is a rule (the mandatory participation rule) that requires just the opposite. It tells some airlines that they are required by the government to agree to participate in the CRSs, ensuring that they will have no ability to negotiate.

- Provisions of Part 255 were intended to enable travel agencies to book by means other than the CRS with which they have a contract – and there is now better technology than ever that should make that possible – but CRSs continue to use highly restrictive business practices to defeat the purpose of these rules.

If we were now simply to sunset the CRS rules, we would rapidly shift from a situation in which the rules not only have on balance failed to restrain CRS market power, but have actually protected it and entrenched it, to a situation where the CRS monopolists, empowered by years of government protection, are able to impose their will without any restraints at all. To end the CRS rules now would let loose CRSs more dominant than they would have been without the last decade of regulation. The CRSs, regardless of their ownership, would have strong incentives to bias their displays and to impose parity requirements on airline participants. That would, in and of itself, be a government-created distortion of the market. Of greatest concern is that CRSs, with their market power intact and with no rules at all, would impose contract terms that effectively would bar new competition from entering the CRS business. What the industry instead needs is a period in which a transition-minded rules allow competition to become a significant factor in the CRS business, so that the rules, when ended, will be lifted from a market disciplined by competition, and not from one that would be dominated by government-fostered monopolists.

To do that, we need rules that, instead of trying to make the absence of competition tolerable, instead make it possible for competition to effectively discipline the CRS marketplace, as competition now does in the online agency marketplace. That will require rules that bring to the CRS marketplace the same pro-competitive ingredients that have enabled the online agency business to become effectively competitive:

- CRS users need to be able to readily use other systems, or switch entirely.
- Any CRS willing to lower its booking fees enough to obtain widespread webfares should, in return, be able to obtain expanded use of its system.
- CRSs and airlines should have sufficiently equal leverage so that neither can dictate to the other, both have to compete for each other's business, and the balanced negotiation that results will produce balanced efficiencies.

The comments below suggest specific changes in the CRS rules that would enable these three ingredients to exist in the CRS marketplace, would allow competition to develop in the CRS marketplace as it has done in the online agency marketplace, and would do so as rapidly as possible. Orbitz proposes this as a transition rule to the time when competition in the CRS arena would be sufficient to allow the sunset of Part 255.

II. CERTAIN RULE CHANGES ARE NECESSARY TO ENSURE AN EFFECTIVE TRANSITION TO A COMPETITIVE CRS MARKETPLACE.

A. The Mandatory Participation Rule Should Be Repealed.

As the Department has proposed, the mandatory participation rule should be repealed in its entirety, effective thirty days after the publication of the revised rules in the Federal Register.

The mandatory participation rule ironically has proven to be a hair-of-the-dog remedy. The market power problem that Part 255 was intended to solve when it was adopted in 1984 was that no airline had leverage to negotiate with a CRS, because no airline – as a practical matter – could decline to participate in a CRS if that CRS would not negotiate with the airline. But the mandatory participation rule, adopted in 1992, went a step further: certain airlines were *required* to participate in each CRS, without regard to the services that it provided or the prices that it charged for its services. As a result, an airline that is subject to the rule has no recourse at all when a CRS refuses to negotiate. The rule functions as a government-granted monopoly. It requires the airline to buy CRS services, but provides no guarantee to the airline that the services will be offered on reasonable terms.

Nominally, the mandatory participation rule requires an airline that is a system owner to participate in each other system "if the other system offers commercially reasonable terms for such participation." 14 C.F.R. § 255.7(a). However, the rule further provides that:

> Fees shall be presumed commercially reasonable if: (1) They do not exceed the fees charged by the system of such system owner in the United States or (2) They do not exceed the fees being paid by such system owner to another system in the United States.

The net effect of these provisions is to functionally prohibit price competition with respect to any airline owning an interest in a system and any other system.[15]

Today, only three domestic airlines are covered by the mandatory participation rule: American, Delta, and Northwest.[16] However, it continues to adversely affect the prospects for

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[15] Clause (1) has the following effect: An airline owning a share in a small system cannot afford to have the system it owns set its booking fees materially below those of the large systems (or materially above them, either). If the small system were to set its fees low, the airline would lose the partial offset that its system's revenues provide to the excessive booking fees that the airline pays to the large systems. Moreover, by pricing low, the small system would bring no competitive pressure on the large CRSs, since the large CRSs compete only for new agencies, and it is the airlines and not the agencies that pay the booking fees. The airline would thus lose more in booking fees if its system's fees were below those of the large CRSs. Furthermore, if it set its bookings fee high, the small system would gain no comparative advantage, since the large CRSs could be expected to promptly raise their fees to the same level. As if that were not enough, clause (2) has the following effect: Since both Sabre and Galileo have market power to dictate the level of booking fees, under this clause Sabre's fees will be justified by Galileo's fees, and Galileo's fees will be justified by Sabre's fees. The net effect is that an airline with an equity position in a system is precluded from ever insisting on a negotiation with a system and using the possibility of not participating to get that negotiation.

[16] Worldspan – the third-largest CRS, based on U.S. agent locations – has announced a plan by which its airline owners – American, Delta, and Northwest – would sell it to Citigroup Venture Capital Equity Partners L.P. and Teachers' Merchant Bank. See "Worldspan to be Acquired by Private Equity Firms," Press Release (March 3, 2003). If this proposed sale closes as planned in the summer of 2003, no domestic airline would still be covered by *(continued...)*

competitive behavior in the CRS marketplace. With the first, third, and fourth largest airlines effectively prevented by the rule from bargaining with CRSs for better services and fees, it becomes far less likely and far more difficult for any other airline to insist on such bargaining. Any such effort could be immediately rebuffed, with the CRSs secure in the knowledge that airlines representing roughly half of domestic capacity could not even make such an effort.

When the mandatory participation rule was adopted in 1992, it was a no cost rule – i.e., at that time, there was no prospect of airlines bargaining with CRSs for better services and fees, nor was there much hope that such a state of affairs would arise. Today, the prospect of airlines having widespread, viable alternatives to CRS distribution may be over the horizon. There is the possibility of a future day on which an airline can insist on negotiations with a CRS, and have a viable choice of reaching the same agencies via other competing distribution channels. It is not here today, but we at least can now imagine that such a state of affairs could come into existence in the next few years. The Internet is the technological mechanism for new entry in the CRS marketplace, a mechanism that did not exist in 1992. We can foresee that entities could enter the CRS marketplace via the Internet, and build their strategies around offering better information and more fares (including webfares from many airlines), and also around obtaining those fares by offering substantially lower booking costs to the airlines. This is how Orbitz already has brought competition to the online agency marketplace, and is what needs to happen in the CRS marketplace. But it is less likely to ever happen if the mandatory participation rule is continued.

Indeed, it is telling that one of the few parties that has expressed satisfaction with the mandatory participation rule as it exists today is Sabre, the largest CRS in the world. See, e.g.,

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(continued...)
the mandatory participation rule, which would be a further reason to repeal the rule as an anachronism. The rule could only do anti-competitive harm if circumstances ever again made it effective.

Comments of Sabre, at 19 (Sept. 22, 2000). The Department should be deeply concerned that the most dominant of the CRSs that Part 255 was most intended to restrain is satisfied with the status quo. As well it should be, since the rule is a critical piece of the armor protecting its market power. An "airline's best market mechanism to prod the CRSs to act [is] the real threat of a downgrade on only the offending CRS vendor." Comments of the U.S. Department of Justice, Docket OST-96-1145, at 8 (Sept. 19, 1996). The mandatory participation rule works against the very competition that the Department should be attempting to introduce to the CRS marketplace, so that the CRS rules one day can be sunset.[17]

B. The Anti-Parity and the Anti-Tying Rules Should Apply Equally with Respect to All Airlines.

In conformity with the repeal of the mandatory participation rule, the anti-parity rule (proposed Part 255.6(d)) should apply equally with respect to all airlines. The parenthetical clause in the first sentence would become an anachronism after the repeal of the mandatory participation rule; thus, the parenthetical clause, as well as the entire second sentence, should be deleted.

The Department's purpose in this proceeding is to foster competition. One of the tools airlines need to create that competition is the option of declining to participate in a system, or of choosing to participate at a lower service level, as a way of trying to induce the CRS to negotiate with the airline with respect to price and service. The anti-parity rule was adopted to accomplish

[17] In addition, Orbitz supports the Department's finding that the concerns which led to the adoption of the mandatory participation rule do not support its extension to the distribution of airline tickets via the Internet. See 67 Fed. Reg. at 69414. Airlines repeatedly have stated that they can and will offer webfares through any online agency that would assist them in lowering their distribution costs, by providing better terms and conditions than do the dominant CRSs. See, e.g., Reply Comments of Northwest, at 5 (Oct. 23, 2000). And, as noted *supra*, that is precisely what has happened since early 2002.

this precise purpose. The NPRM described the state of affairs that existed before the anti-parity rule was adopted in 1997:

> The parity clauses imposed by most systems on airline participants required each airline to buy at least as high a level of service from the system as it did from any other system. The parity clauses made it unnecessary for systems to compete for airline participation at higher levels of service....

67 Fed. Reg. at 69380-81. However, the Department at that time exempted airlines that owned or marketed a CRS from the new rule, so that the anti-parity rule would be consistent with the mandatory participation rule. See, e.g., 62 Fed. Reg. 59784, at 59797 (Nov. 5, 1997). But given that the Department has recognized that the mandatory participation rule should be repealed, because it is contrary to the interests of competition, there likewise is no longer any justification for this exemption to the anti-parity rule.

A contract-based counterclaim recently filed by Sabre against American exemplifies the parity problem.[18] Sabre has provisions in its participating carrier agreement with American that require American "to provide as advantageous and uniform reservations services to all Sabre subscribers as it provides through any other GDS." Id. at § 2.1. Such a provision would not be allowed under the anti-parity rule if the contract were with an airline that did not own or market a CRS, such as Continental, but it is allowed by the existing anti-parity rule if the contract is with an airline that does continue to own or market a CRS, such as American, Delta, or Northwest.

There is nothing inherently anti-competitive about parity clauses. But parity clauses in the hands of an entity with market power can become a powerful device for maintaining that market power against any threat of new competition. Because a CRS has the power to dictate the terms and conditions of its services to an airline, it can dictate a parity clause designed to prevent

[18] American Airlines, Inc. v. Farechase, Inc., District Court of Tarrant County, Texas, 67th Judicial District, No. 67-194022-02, Intervenor's Original Counterclaim (filed Jan. 13, 2003). Sabre is the Intervenor. See Appendix D.

that airline from gaining any bargaining power vis-à-vis that CRS. It is important that all airlines have a credible option of downgrading their participation in a CRS in order for them to have a realistic opportunity to negotiate with a CRS for better services and fees.

For the same reasons, in the newly proposed anti-tying rule (proposed Part 255.6(e)), the clause "unless that carrier owns or markets, or is an affiliate of a system that owns or markets, a foreign or domestic computerized reservations system" should be deleted.

Without these changes to the anti-parity rule and the anti-tying rule, to conform with the repeal of the mandatory participation rule, it would be difficult for competition to emerge in the CRS marketplace. The Department would have largely perpetuated the effects of the mandatory participation rule by alternate means, even after deleting the text of the mandatory participation rule from Part 255.

More broadly, the anti-parity and anti-tying clauses are essential to moving the CRS industry to a point where the CRS marketplace can be disciplined by effective competition and not by economic regulation. Without these clauses the industry simply will not make the transition to competition. These clauses are perfect exemplars of why a precipitous ending of all CRS rules would doom competition in the CRS marketplace, not open the door to it. The largest CRSs clearly have market power over any airline with a significant degree of dependence on CRSs. If there were no anti-parity rule and no anti-tying rule while the CRSs still had that clear dominance, they would use it to force participation requirements onto airlines that would prevent competition from ever emerging.

The Department needs to understand this very clearly. Sabre would use the fact that virtually no airline could survive for even a few days without its revenues booked through Sabre to force contractual provisions on airlines that would forever prevent price competition in the

CRS marketplace. Specifically, Sabre would require, as a condition of continuing to be displayed and booked through Sabre, that an airline offer all of its fares through Sabre without regard to the fees Sabre charged or the quality of service Sabre provided. That is the position that Sabre already has begun to stake out in its counterclaim in American v. Farechase. That would effectively end any prospect of competition ever developing in the CRS industry; Sabre would have used its present market power to eliminate any future possibility of new competition. In a zero-rule environment, the infant possibility of the CRS industry becoming truly competitive would be strangled in its crib.

Finally, the Department should also take this opportunity to clarify three further matters related to these provisions of Part 255.6:

- First, in order to obviate any claim of confusion at a later date, the Department should clarify that the provisions in the Sabre Participating Carrier Agreement that are at issue in its counterclaim against American (see Appendix D), specifically §§ 2.1, 2.4, and 2.16 (to the extent that it requires American to participate in Sabre at the same level as it participates in other systems) would violate the existing anti-parity rule if American were not currently a system owner, and would violate that same rule if the parenthetical clause and second sentence were deleted from the proposed Part 255.6(d).

- Second, consistent with the Department's objective of fostering competition by making it necessary "for systems to compete for airline participation at higher levels of service," (67 Fed. Reg. at 69392) the Department should clarify the intended effect of the proposed Part 255.6(d) and Part 255.6(e) with respect to competitive price initiatives. The Department's intent clearly is to make it possible for a system to become a price competitor by offering the option of lower booking fees in return for an airline's willingness to sell fares available elsewhere, such as webfares, through that system. That behavior, which the Department presumably wants to encourage, is distinct from a system demanding that an airline to provide it with access to fares available elsewhere, regardless of that system's fees or services, or risk being downgraded in or removed from the system. The former is a price-discounting option; the latter is an ultimatum without price inducements. The Department should clarify that the proposed Part 255.6 would encourage the former and prohibit the latter.[19]

- Third, in its proposed Part 255.6(e), the Department provides that: "No system may require any carrier as a condition to participation to provide it with fares that the carrier has chosen not to sell through any other system." The Department should clarify that the existing anti-parity rule already prohibits any system from requiring an airline, as a condition of participation, to provide that system with fares that the carrier has chosen to sell through another system, but not through all systems.

C. The CRS Rules Should Not Be Extended to the Internet.

The Department has proposed not to extend Part 255 to online travel agencies. See 67 Fed. Reg. at 69411. This is the correct decision. The CRS rules never were designed for such a purpose. The root of CRS market power – which is what Part 255 *was* designed to address – is that each CRS has virtually exclusive access to most of the travel agencies it has under contract. According to the most recent ASTA Agency Automation Study (2002), 93.6% of agencies use only one CRS. See id. at 34. This, in turn, gives each CRS market power over the airlines; each

[19] This conclusion seems especially evident, given the Department's proposal that Part 255.6(e) would prohibit tying to fares offered elsewhere in cases of "higher booking fees" or "poorer service." See 67 Fed. Reg. at 69393.

CRS continues to be the only means by which to reach a significant percentage of agencies. In contrast, online agencies have no such hold over their users. Online agencies have no contracts with their users – and their users have no inhibitions about constantly switching among websites, comparing their search results, and placing their next booking wherever it seems most advantageous to do so. See 67 Fed. Reg. at 69411.

In sum, the problem that the CRS rules were designed to fix simply does not exist on the Internet.

Moreover, as discussed *supra*, online agencies have been transformed since the launch of Orbitz. They now comprise a highly-competitive marketplace, in which pricing moves and counter-moves occur frequently, where negotiation for lowering booking costs is common, where a new entrant (Orbitz) has gained significant market share by virtue of being a price leader with respect to booking costs, and where negotiations between distributors and suppliers over the costs of bookings and access to inventory have become the norm. Online agencies now are a model for a competitive distribution marketplace. Not only would the Department have no purpose in extending Part 255 to the Internet, but it would have no legal basis for doing so, because there is no current or imminent market power problem to fix. Cf. 67 Fed. Reg. at 69385-87.[20]

That is not to say that online agencies should be beyond the reach of the Department, nor that they should not be subject to any regulation. Online agencies are fully subject to the Department's rules and policies regarding deceptive practices adopted under the authority of

[20] Orbitz also supports the Department's decision not to require airlines to treat all online agencies – or all agencies – the same. See 67 Fed. Reg. at 69413. A rule which required airlines to use a distribution channel without regard to service quality or costs would work against the interests of competition and consumers. Moreover, as has been true ever since deregulation, "the pro-competitive policy directives in 49 U.S.C. § 40101 allow airlines to choose the channels for distributing their services as well as the prices and terms of sale for different channels, subject, of course, to the antitrust laws that govern firms in other unregulated industries." Order 2000-10-13, at 4-5.

Section 411 (49 U.S.C. § 41712), which the Department actively enforces. See, e.g., Order 2002-3-28 (consent order sanctioning Sabre's Travelocity for violations of 14 C.F.R. § 399.84); Order 2001-12-1 (consent order sanctioning Expedia for violations of 14 C.F.R. § 399.84); Order 2001-6-3 (consent order sanctioning Galileo's Trip.com for violations of 14 C.F.R. § 399.84).

The Department's has proposed a tailored approach – that is, to continue its CRS-specific rules on account of the CRSs' continuing market power, but not to extend Part 255 to online agencies, because the CRS rules are neither suited to nor justifiable for online agencies. Orbitz supports the Department's approach.

In addition to concluding that Part 255 should not be extended to online agencies, the Department also has requested comments as to whether and how Internet-based entities that enter the CRS business (i.e., offer distribution services designed specifically for travel agency use) should be excluded from the coverage of Part 255. See 67 Fed. Reg. at 69390. This issue is an important one, because if there is ever to be a competitive new entrant in the CRS business, this is almost certainly the means by which it would occur. Indeed, this issue could prove to be a determining factor in whether the CRS marketplace is ever characterized by competition, and whether the CRS rules therefore ever can be repealed.

So long as an Internet-based entity does not take on the characteristics that have made CRSs an anti-competitive problem since the beginning (i.e., so long as they do not obtain a virtually exclusive hold on their users), they should not be covered by regulations designed to address the consequences of that CRS market power.[21] For example, if an Internet-based entity offered to any agency that cared to use its services a website with flight and fare information; the

[21] The same would be true, of course, for any legacy CRS. If a CRS were willing to have no contractual hold on its users other than on a transaction-by-transaction basis, it too would not fall within the scope of the CRS rules.

ability to make bookings through that website; the ability to maintain records of those bookings, and to modify those bookings if requested by the agency's customers; and the ability to enter an ARC number and receive any commissions arising from those bookings – but the entity did not hold the agency to any contract, terms, or conditions extending beyond each individual booking – then that entity should not be covered by the CRS rules.

The Department has proposed to modify the definition of "system" by requiring that it be "used by a subscriber under a formal contract with the system" (proposed Part 255.3). An entity that offered such a service to agencies presumably would do so on the basis of some set of mutual obligations between the entity and agencies. Those obligations presumably would be spelled out on the entity's website, and would bind both parties with respect to each individual booking. That certainly could be considered to be a contract, even if it would have no binding effect beyond that transaction. But that agreement, whether or not a contract, would have no bearing as to where the agency would make its next booking, or the one after that. The agency, like other Internet users, would have absolute choice with regard to each subsequent booking. The Department should not put itself in the position where it could be argued that a new competitor, even though it dealt with agencies only on a transaction-by-transaction basis, could be deemed to have a "formal contract" with agencies with respect to each transaction, and thus to be a covered system. Such a new competitor would not and could not try to become an exclusive conduit for an agency's business, and thus would not have the potential for the anti-competitive conduct that Part 255 attempts to limit.

The Department should ensure that any revised definition of "system" would not stifle innovation and competition by being overbroad. That could be done by making clear that the concept of a "formal" contract does not include the type of *a la carte* transactional/short-term relationship that is described above. See 67 Fed. Reg. 69390. Alternatively, the Department could amend the proposed definition itself, to make clear that Part 255 applies to agreements that endure beyond a transactional/short-term basis. In particular, Orbitz suggests the following language:

> "System" means a computerized reservations system offered to subscribers for use in the United States that contains information about schedules, fares, rules or availability of carriers and provides subscribers with the ability to make reservations if it charges any carrier a fee for system services, and if it is used by a subscriber under a contract other than on a booking-by-booking basis.

D. The CRS Rules Should Apply to All CRSs, without Regard to Ownership.

The market power which originally gave rise to concerns about CRSs, and which led to the promulgation of Part 255, was rooted in the fact that each CRS was the exclusive channel to virtually all of the agencies that each CRS had under contract. At the time, every major CRS was owned by one or more airlines, and CRSs typically exercised their market power in ways that advantaged their parent airline(s). But even if a CRS lacks any airline ownership, as is the case for Sabre and Galileo today,[22] that CRS still has the same market power, and still has the incentive and the means to abuse that power, to the profit of whoever its owners may happen to be:

- The CRS still has every incentive and means to charge excessive booking fees.
- The CRS still has every incentive and means to bias its displays – not to advantage its airline-owners flights, but to sell the bias to the airlines best able to pay for such bias.

[22] As discussed *supra*, Worldspan has announced a plan by which its airline owners would sell the system to non-airline owners. Air France, Iberia, and Lufthansa own approximately 60% of Amadeus, the fourth-largest CRS, while the remainder is held by the public. See "Amadeus Investors" <http://www.amadeus.com/en/40/40.jsp>.

- The CRS still has every incentive and means to retain its exclusive hold on agencies by any possible means, in order to preserve its lucrative market power.

See generally 67 Fed. Reg. at 69382-83.

Not only do these anti-competitive abuses continue to be in the interest and the power of a non-airline-owned CRS, but they also distort competition in the airline industry in general:

- These abuses burden air transportation with excessive costs, and do so in ways that particularly disadvantage short-haul and low-fare airlines.[23]

- These abuses in some instances particularly advantage the airlines with the deepest pockets (i.e., if the existing CRS rules were repealed, any and all forms of bias could be sold to the highest bidder).

- These abuses will continue to artificially impair the ability of travel agencies to exercise market choice as to the channels through which they will sell air transportation.

The Department correctly notes that the current foundation for the CRS rules in regard to Sabre and Galileo – that the rules apply to any CRS that is marketed by an airline – is tenuous. See 67 Fed. Reg. at 69384-85. But it is particularly important to understand that Sabre, which lacks any airline ownership, has taken the public position that it continues to be covered by Part 255, because the rules advantage rather than disadvantage its position in the CRS marketplace. Thus, Sabre previously has not had any interest in challenging the marketing nexus. Galileo has only more recently become divested of airline ownership. But if the Department proceeds to adopt revised CRS rules that do not include the mandatory participation rule, Sabre and Galileo

[23] As explained in Orbitz's previous Comments, at 16-17 (Sept. 22, 2000), these airlines pay the same per-segment fees as long-haul and full-service airlines. The fee therefore comprises a far larger percentage of the costs and fares of short-haul and low-fare airlines, which in turn disproportionately burdens the most price-sensitive consumers.

will be confronted by a Part 255 which is on balance pro-competitive – and which does not continue to advantage their dominant market position. Thus, Sabre and Galileo can be expected to challenge the notion that they are within the coverage of Part 255 because they are marketed by one or more airlines. The Department therefore faces the risk that its CRS rules would apply only to the smallest CRSs (or even to only one CRS), and not the two (or three) largest CRSs. That clearly would be an indefensible outcome. The Department would be regulating only the CRS(s) with the least market power.

The Department can and should regulate CRSs directly as ticket agents, as proposed. See 67 Fed. Reg. at 69384. Pursuant to the statutory definition of a ticket agent, any entity that "sells, offers for sale, negotiates for, or holds itself out as selling, providing, or arranging for air transportation" must be either an air carrier or a ticket agent. See 49 U.S.C. § 40102(40). If CRSs fall within the scope of this definition, CRSs are within the coverage of Section 411, and the Department has authority to impose the obligations of Part 255 directly on them. Thus, the question before the Department is not whether CRSs are travel agencies, but whether they arrange for air transportation. Clearly, they do; therefore, they must be either air carriers or ticket agents. There is no statutory alternative.

This is not a novel position that the Department has devised for this rulemaking. The Department, the Civil Aeronautics Board and the courts, previously have held that an entity need not be a travel agency to be a ticket agent. See, e.g., Bartering of Air Transportation, 87 C.A.B. 2089 (Jan. 21, 1981) (entity that re-sells airline scrip obtained through barter can be "ticket agent"); Trans World Airlines, Inc. v. American Coupon Exchange, Inc., 682 F. Supp. 1476, 1483 (C.D.Calif 1988), aff'd in part and vacated in part on other grounds, 913 F.2d 676 (9th Cir. 1990) (entity that re-sells frequent flier award certificates can be "ticket agent"); Foremost Intl.

Tours, Inc. v. Qantas Airways, Ltd., 379 F. Supp. 88, 95 (D.Haw. 1974), aff'd 525 F.2d 281 (9th Cir. 1975) (wholesaler of tours can be "ticket agent").

E. The Rules Should Provide Travel Agencies with More Freedom of Choice.

If we are going to get to a point where competition in the CRS marketplace is real – and where we can rely on it rather than on regulation to protect consumers – then providing travel agencies with a real ability to choose is essential to getting there. The Department has indicated that a goal of this rulemaking should be to ensure that travel agencies will have a choice as to which system they will use to make each air transportation booking, as well as to whether to switch their system outright. See 67 Fed Reg. at 69406.

The Department is correct. So long as the CRSs can use their market power to dictate contract terms that inhibit travel agencies from using other systems, or from switching systems (terms which they impose under the existing CRS rules, and which they would continue to have the power to impose in a zero-rule environment), then the CRS marketplace will continue to be denied real competition. As the Department has recognized: "Every system seems to continue to engage in subscriber contract practices that keep airlines and travel agencies from using alternatives to the systems and thereby entrench each system's market power." 67 Fed. Reg. at 69383. Moreover:

> The systems continue to use contract terms that limit the travel agencies' ability to switch systems or use multiple systems.... The [contract] provisions limit competition, maintain the systems' market power, and keep airlines from bypassing the systems in communicating electronically with travel agencies. They also inhibit innovation, by discouraging firms from developing new services and products that travel agents could use as alternatives to the systems.

67 Fed. Reg. at 69405. In other words, the existing CRS rules have been ineffective in bringing competition to the CRS marketplace, since the purpose of regulation, with respect to subscriber

contracts, was to enable agencies to make bookings through alternative channels and to switch to alternative systems. "The Board therefore sought to ensure that travel agencies had a reasonable opportunity to switch systems or use multiple systems." 67 Fed. Reg. at 69405.

Therefore, for a transition rule to work – i.e., to get us to a point where we can rely on real and effective competition instead of economic regulation to govern the CRS marketplace – travel agencies must have a realistic opportunity to make bookings through alternative channels, and to switch to another system that offers them better economics, better fare options, or other features that enable them to better serve their customers. The bedrock of CRS market power is the hold that each CRS has on nearly every agency that it has under contract. Until agencies have an effective option to take their business elsewhere, either on a booking-by-booking basis, or in its entirety, a CRS need not worry that it has not bargained with airlines for their full range of fares, because that CRS already has a captive audience. In short, price competition will not arrive in the CRS marketplace until the original goal of providing agencies a real opportunity to book through alternative means or to switch systems is fulfilled.

Why has the clear intent of the Board and the Department – to ensure travel agencies real competitive choice – failed to produce results? Technology is not the limiting factor; business considerations and contract terms are.

Central to this question is the effect that the Internet has had on travel agencies. Despite the growth of the outlets and information available via the Internet, for travel agencies, the more things change, the more they have remained the same. The ASTA Agency Automation Study (2002) is illuminating. Agencies now have a very high level of access to the Internet – 98% reported having Internet access in 2002, up from just 24% in 1995. See id. at 12. Moreover, agencies now make extensive use of the Internet – an average of 10.5 hours per week for front-line agents, and 14 hours per week for managers. See id. at 16. But agencies primarily use the Internet for gathering information, especially on destinations. See id. They rarely make bookings via the Internet: "...adoption of Internet booking practices by the travel agency community remains low." See id. at 18, 20. Moreover, when agencies do make a booking via the Internet, it is likely to be for a vacation package, and not an airline ticket. When agencies were asked which websites they used to make bookings, of the top ten sites, only two issue air tickets, and they were Southwest (#5) and JetBlue (#7), both of which have only limited availability through CRSs.[24] See id. at 19.

The bottom line is that the promise of the Internet to be the long-absent technology that would offer real choices to travel agencies has not been realized. The technology is in place, but business considerations and contract terms continue to limit its competitive effect. That is the stumbling block that a transition rule must correct in order to enable competition to go to work.

It also is true, as the Department has recognized, that an improvement in agencies' ability to choose, on an ongoing basis, which system or systems they will use would not only be a benefit to competition, but a benefit the agencies themselves. "Enabling travel agencies to use multiple systems and databases and to switch systems promotes competition. When travel agencies can choose among [system] suppliers, they are likely to obtain better prices and service." 67 Fed. Reg. at 69407.

The Department has proposed several amendments to its rules for subscriber contracts. Orbitz in particular endorses curbs on productivity pricing, as well as revised limitations on the

[24] Southwest, as discussed *supra*, does not participate in any CRS but Sabre, and is the only airline to have any success in pursuing a strategy premised on refusing to pay full CRS booking fees. Southwest correctly has concluded that not being burdened by those excessive CRS booking fees is a key to viability for any airline.

length of contract terms, limitations on liquidated damages clauses, and broader access to third-party software.

1) Productivity Pricing

Productivity pricing is a key barrier to agencies using multiple systems, or considering using multiple systems or alternatives. The existing CRS rules provide that "[n]o system may directly or indirectly impede a subscriber from obtaining or using any other system," and in particular they prohibit systems from imposing a minimum-use clauses on a subscriber. See Part 255.8(b). Nevertheless, productivity pricing is an indirect, yet highly effective, means by which to impede agencies from using other systems or other channels of distribution. Typically, an agency is charged a monthly fee for CRS equipment and services, but some or all of that fee will be forgiven if that agency achieves a specified level of segments booked per month. See, e.g., Comments of Midwest Express, at ex. 9 (Dec. 9, 1997); Comments of the Large-Agency Coalition, at 6 (Dec. 9, 1997). Thus, the agency is on a perpetual treadmill that demands it to make to as many bookings as possible through that CRS, in order to reduce its payments to that CRS. This is a very effective impediment, and no longer has – if it ever did – any linkage to the efficient use of a system's equipment. As the Department rightfully has recognized, "productivity pricing deters travel agencies from using multiple systems or direct connections with an airline's internal reservations system." 67 Fed. Reg. at 69405. Moreover, the Department also has acknowledged that, in practice, productivity pricing "operates as the equivalent of the minimum use clauses that we prohibited when we last reexamined our rules." 67 Fed. Reg. at 69409.

The Department's proposal to limit productivity pricing therefore has the right objective. But the Department should clarify that it does not intend to prohibit certain other practices, such as an agency's acceptance of a signing bonus for agreeing to sign up with a particular system, so long as such payments are not contingent on the agency using the system for any particular number or share of transactions. The Department's prohibition of productivity pricing should be strictly limited to provisions that adjust the pricing of the system or equipment based on the extent to which it is used by an agency, such as the number of bookings or the share of total bookings.[25]

Moreover, the Department must find a means by which to end productivity pricing – which has clear anti-competitive effects – without, at the same time, penalizing travel agencies, which would be counterproductive to the goal of improving the competitive position of travel agencies. However pernicious the effects of productivity pricing may be, many agencies currently rely on it in order to get reasonable pricing terms out of their existing CRS contracts. If productivity pricing came to an end, but the rest of an agency's CRS contract remained intact, it would be a contract that the agency would not have signed and could not afford. Such an outcome would be unfair to the agency, in many instances, and harmful to competition and consumers in general. Therefore, the Department should adopt a special transitional rule on productivity pricing, in fairness to agencies who have productivity pricing provisions in their current contracts. There should be an "open season" option period for all such agencies, during which they would have an opportunity to renegotiate their contracts – and to make that opportunity meaningful, they should have the right, if they cannot negotiate a satisfactory modification to their contracts, to end their contracts and switch to another system without penalty. This "open season" could last for 90 days after the new rules in general have entered

[25] The proposed Part 255.7(c) refers only to the share of bookings; in conformity with the above, the Department should clarify that this rule also is intended to apply to productivity pricing based on the number of bookings made by an agent.

into effect. Under these conditions, agencies would have a real chance to renegotiate their systems contracts at reasonable overall costs, and to be released from the gilded cage of productivity pricing. Agencies should have the opportunity to replace productivity pricing with alternative forms of compensation.

To be specific, each agency with a productivity pricing feature in its contract would have, during this one-time open season period, the following options:

- The agent could keep its current contract, minus the productivity pricing clause that was prohibited by the new rule.
- The agency could negotiate with its current CRS for a modified contract without productivity pricing, but with overall economics that were acceptable to both the agency and the CRS.
- The agency could elect to exit without penalty its existing contract and sign a new contract with any other CRS, or to contract with a new CRS in addition to keeping its contract with its existing CRS.

The choice among these options would be solely in the hands of each travel agency, and could be exercised at any time during the course of that open season.

2) Maximum Term of Travel Agency Contracts

In addition to ensuring that agencies have a real option to make bookings on more than one system, it is also important that the CRS rules ensure that agencies have a real option to switch to another system entirely, even if they never actually exercise that option. The more realistic it is that agencies could switch systems, the more likely it is that their existing system will not be able to dictate inflexible terms. And if systems did not dictate inflexible terms, agencies would not have the same incentives to actually switch. Moreover, if agencies had such increased leverage, they would be in a better position to negotiate for contractual terms that did not effectively limit them to the use of one system.

The CRS rules currently set the maximum term for a travel agency contract at five years; systems must also offer agencies a three-year contract, but they are not required to make its terms attractive (and indeed, they often do not). See Part 255.8(a). Multiple parties have urged that CRS contract terms be shortened, ranging from ASTA (Comments, at 9-16 (Dec. 9, 1997)) to Delta Air Lines (Comments, at 8-9 (Sept. 25, 2000)) to Amadeus (Reply Comments, at 30-31 (Oct. 23, 2000)). The very least change that the Department should adopt would be to set the maximum term for a travel agency contract at three years.

The better solution would be for the Department to also adopt the European model for the term of travel agency contracts: after one year, the agency can end the contract and switch systems on no less than 90 days notice. See Council Regulation No. 2299/1989, as amended by No. 3089/1993 and No. 323/1999, Article 9(4). The European rule is the right approach in that it both ensures a minimum commitment to the CRS, during which the CRS can recover its set-up costs, but it also gives travel agencies the option of subsequently ending the contract, which gives them leverage on an ongoing basis to secure more equitable and less restrictive contract terms.

However, in practice the European rule has not been particularly effective in creating choice and competition for travel agencies, because the European CRS rules do not prohibit the "shingling" of contracts for hardware or peripheral services provided by a CRS. As is also the practice under Part 255, the term of such contracts run for overlapping terms with the original contract. See Fed. Reg. at 69407-08. Therefore, under both Part 255 and the European CRS rules, an agency can end up with not one contract, but two, three, or more contracts with the same CRS, and all of these contracts run for terms that overlap; as a result, an agency never gets to a point where it is in a free-and-clear position to switch systems. See id. See also Comments of Worldspan, at 10 (Dec. 9, 1997); Reply Comments of the Large-Agency Coalition, at 4 (Feb. 3, 1998); Association of European Airlines, Economic and Political Analysis of Computer Reservation Systems, at 14 (Oct. 2001). The end result is that the exit option under the European CRS rules is neither much used nor a credible means by which to obtain better contract terms for travel agencies. Nor is the maximum contract term provision of Part 255 as effective as it should be.

The Large-Agency Coalition has proposed in this rulemaking that any new or modified CRS contract should be required to run for the same term as the original contract. See 67 Fed. Reg. at 69408. Orbitz agrees. Otherwise, the entire concept of requiring CRS contracts to have a maximum term can be rendered a sham in the real world. If the Department is going to make a seriously effort to enable agency choice and CRS competition that will ultimately permit the CRS rules to be sunset, it needs to close the anti-competitive loopholes (like the shingling of contract terms) that will allow CRSs to continue to impede competition.

The effective date of these changes should be the date on which revisions to Part 255 in general take effect, and should apply to any new contract entered into beginning on the effective date. The changes should also apply to existing contracts, although the Department may wish to provide an additional 60 days will elapse before the new rules on contract terms take effect with regard to existing contracts, so any contracts that would have expired or be about to expire under the new rules could be renegotiated by agencies and CRSs.

3) Liquidated Damages Clauses

The Department also should strictly limit the types of damages that a CRS can impose on an travel agency when that agency elects to switch to a different system. As the Department has recognized, a CRS cannot reasonably expect an agency to use that CRS for all or most of its bookings during the term of the contract. See 67 Fed. Reg. at 69407. Nevertheless, CRSs frequently require agencies to pay a large sum in liquidated damages, if they end a contract early. See, e.g., Comments of ASTA, at 24-25 (Dec. 9, 1997); Comments of Delta Air Lines, at 18-20 (Sept. 25, 2000); and Reply Comments of Amadeus, at 31 (Oct. 23, 2000)).

The Department's proposed limitations (proposed Part 255.7(a)), although a step in the right direction, are still too narrowly drawn to be effective in promoting choice for agencies. The Department's proposal would limit the damages a CRS can assess based on "lost" bookings, but would allow a CRS to devise almost infinite other pretexts for imposing damages designed to keep an agency from switching systems. The Department and travel agencies are well aware, based on their nearly 20 years of experience with the subscriber contracts provisions of the CRS rules, that if these provisions are drawn narrowly, the CRSs will find alternative means by which to impede competition.

The Department instead should provide, with respect to damages, that damages (whether actual or liquidated) may not exceed the actual cost of the physical removal of system owned-equipment and connections, if any. This provision would parallel, but yet be more specific than, the equivalent provision of the European CRS rules, which limits damages to "costs directly related to the termination of the contract." See Article 9(4)(a). See also Article 36(f) of the Canadian CRS rules (SOR/95-275).

The effective date of this change should be the date on which revisions to Part 255 in general take effect, and should apply to any existing contract and any new contract entered into beginning on the effective date.

4) Third-Party Software

For travel agencies to have – in the real world – a realistic option to place bookings through more than one system, they require some means to keep track of bookings by passenger names, such that when an agency receives a request from a customer to change a reservation, the agency can easily determine where, when, and how that reservation was made. In addition, agencies also need a means by which to automatically track other data, such as the number of bookings made, the responsible agent, the commissions generated by bookings, overall revenue trends, and similar types of considerations that are crucial for any business. It is not practical for most agencies to have multiple pieces of hardware to access different systems, or to have multiple software programs that do not interact with each other. To practically access information in and make bookings through multiple systems, an agency must have the ability to access and book multiple systems through a single piece of hardware, and must have the ability to obtain and use software that will track bookings – without regard to the channel use for each booking – by passenger name and perform the variety of other functions necessary to the operation of the agency as a competitive business.

The availability of third-party software on the same computer that an agency uses to access a CRS is as crucial to the development of competition in the CRS marketplace as the revisions to the subscriber contract rule described above. Agencies not only need choice as a theoretical principle, but also need a real-world ability to access and use those choices.

Given the ubiquity of the Internet and the entrepreneurial nature of the software industry, it is not technological limitations that have prevented agencies from having the access and the software necessary to make agency competitive choice a reality. Once again, the stumbling block has been CRS-related business considerations and contract terms. The Department was correct when it concluded that "... we presently believe that the systems' contract practices may be the major reason for the travel agencies failure to use multiple systems and databases." 67 Fed. Reg. at 69391.

The major impediment to competitive choice is the provision of the existing Part 255.8 that limits an agency's ability to use third-party software to those instances where the agency owns its own hardware. Most agencies do not own the computers that they use to access CRSs, even though dumb terminals long since have been superceded by off-the-shelf hardware. Even in the latest ASTA Agency Automation Study, over 70% of the agents surveyed reported that they still use equipment owned by the CRS with which they are under contract. See id. at 33. This fact, by itself, means that the third-party software rule does not even apply to a substantial majority of all agencies. Moreover, the current rule also leaves an open opportunity for the CRSs to defeat the intent of the rule by incentivizing agencies to use CRS-owned equipment – and indeed, this is what they have done ever since it was enacted over ten years ago. See Comments of Reed Elsevier, Inc., at 4-5 (Dec. 9, 1997); Comments of the Large-Agency Coalition, at 3-4 (Dec. 9, 1997).

The Department has proposed to amend the third-party software rule such that it will apply to all agencies that use CRSs, regardless of whether the equipment they use is CRS-owned or not. Orbitz agrees. Nothing less is going to ensure agencies competitive choice. See also Article 36(d) of the Canadian CRS rules.

The Department has also taken the important step of making clear that the third-party software rule includes within its scope back-office systems, and that CRSs may not accomplish by pricing what they would be prohibited from doing outright. See 67 Fed. Reg. at 69392. Orbitz agrees with both of these proposals. The former is important because most agencies cannot avail themselves of the option of making bookings through more than one channel without the use of a back-office system that can maintain the records they need to operate their businesses. The latter is important because CRSs have a long history of using pricing as a means to achieve what is otherwise prohibited (i.e., the use of productivity pricing as a means to circumvent the rule prohibiting minimum use clauses), and likely would demand disproportionately high fees from subscribers that did not use CRS-provided equipment, or that used third-party software, if not prevented from doing so. As the Department has recognized, it should not adopt rules that the CRSs routinely can evade. See 67 Fed. Reg. at 69406.

The effective date of this change should be the date on which revisions to Part 255 in general take effect, and should apply to any existing contract and any new contract entered into beginning on the effective date.

III. PART 255 SHOULD SUNSET IN THREE YEARS IF THE REVISED RULES HAVE ESTABLISHED COMPETITION IN THE CRS MARKETPLACE

In the past, the purpose of the CRS rules was to prevent abuse of the market power that the CRSs clearly possessed, and to prevent those abuses from distorting airline competition and harming consumers. The revised CRS rules should share that purpose. But the Department also should ensure that the revised CRS rules serve the purpose of opening the door to the new competitive forces new technology has made feasible. This would allow, at the earliest possible time, for the CRS marketplace to be effectively disciplined by competition, rather than by economic regulation.

Under the existing rules, it will be a long time – if ever – until the CRS marketplace has become sufficiently competitive to allow the CRS rules to be eliminated without real harms to competition and to consumers. However, if the CRS rules are revised to do what they should do – i.e., to enable competition to develop – real competition will be brought to bear for the first time in the CRS marketplace. Once that has occurred, the rules can sunset. And the faster that revised rules accomplish their mission of enabling competition to be effective, the faster the rules can be sunset.

The question of when the CRS rules should sunset depends entirely on what revisions the Department makes to those rules. Orbitz believes that the rules should be modified in ways that would enable the earliest possible sunset of Part 255, and has made its recommendations herein accordingly.

The CRS rules should sunset when the CRS marketplace has sufficient competition to discipline that marketplace. How will we know when that moment has arrived?

There are two ways to make that determination. One is to adopt a rule triggering the sunset of Part 255 when some objective criterion is met: for example, when the largest CRSs' bookings fall below a stated percentage of all domestic airline bookings. There are three problems with this approach, however. First, the determination of what trigger to use is itself a highly subjective determination (albeit one informed by the considerable policy expertise of the Department). Second, the underlying data sets, while accurate enough to permit estimates of market share and market power, are not so accurate as to facilitate arguments about fractions of a percentage point. Third, there would be a time lag between the trigger event, the reporting of the data, and the sunset of the rules that would be inconsistent with the intended purpose of a sunset provision. Orbitz does not believe there is an appropriate measure that could serve as an automatic trigger for the sunset of the CRS rules.

The other approach is a functional one. The CRS rules would sunset when it appears to the Department that that the purpose of the transition – that is, the facilitation of competition in the CRS marketplace – has been accomplished. This approach is no more subjective, or less objective, than a trigger mechanism, and it would give the Department the flexibility to address the actual mechanics of the marketplace. We know what a competitive CRS marketplace would look like: airlines and CRSs would each have sufficient leverage to negotiate agreements on booking fees and webfares; CRSs would have incentives to lower their booking fees to obtain webfares, sufficient to incentivize travel agencies to switch to their system, or at least use it more; and travel agencies would in fact be able to use different channels as best suited them and their customers, and to switch systems entirely if they preferred. It will be evident when those characteristics are typical in the CRS industry.

Orbitz recommends that, if the Department adopts revisions to the CRS rules which are genuinely pro-competitive, as suggested herein, the Department also should extend the duration of the rules for a period of three years. Moreover, the Department should make clear that its intent is to sunset the rules after that period, unless it has been shown that there is not yet real and effective competition in the CRS marketplace. In particular, Orbitz recommends that the following language be adopted in place of the existing sunset provision in Part 255:

> The rules in this part shall terminate on [three years after the date of publication in the Federal Register] unless it shall be demonstrated to the satisfaction of the Department that competition does not exist in the marketplace for computer reservations systems, as evidenced by the absence of factors such as (a) negotiated agreements between air carriers and systems with respect to booking fees and access to webfares, (b) competitors reducing booking fees to obtain

> widespread access to webfares, and in turn attracting additional use by travel agents, and (c) subscribers switching systems, using other systems, or booking air transportation through alternative means. Any person may petition the Department to extend the rules beyond [three years after the date of publication in the Federal Register], provided that such petition must be filed by [30 months after the date of publication in the Federal Register].

If the Department makes clear that it intends to sunset the CRS rules after three years, but that it will do so only if there are real improvements in competition in the CRS marketplace, such gains will be far more likely to occur, because the largest CRSs are among the parties most interested in the sunset of the rules (at least to the extent that they cannot perpetuate the features of the existing rules that have helped them to entrench their market power).

IV. ADDITIONAL MATTERS

A. Policy on Fare Advertising

The Department has proposed to amend Part 399.84 to require that travel agencies (both online and offline), when advertising or stating an airfare, state the total amount to be paid by the consumer, inclusive of the agency service fee (if any), and separately state the amount of their service fee. See 67 Fed Reg. at 69417.

The Department traditionally has taken the position that to comply with Part 399.84, a travel agency's service fees must be incorporated into the advertised or stated price. However, in the exemption granted to Orbitz over a year ago (Order 2001-12-7), as well as in an Enforcement Policy that was issued shortly thereafter by the Office of Aviation Enforcement and Proceedings (Notice, December 19, 2001), which applied to all online agencies, the Department adopted certain modifications to that policy. In particular, the Department allowed online agencies to list service fees separately from airfares on a website, provided that agencies that did so adhered to certain conditions. In the NPRM, the Department has now taken the additional step of requiring travel agencies (both online and offline) to separately state the amount of their service fee (if any), and to state the total amount to be paid by the consumer, inclusive of the agency service fee.

1) Service Fee Disclosure

As a general matter, the Department is correct in preferring that all travel agencies follow the same general disclosure principles. Consistent disclosure will benefit consumers, who may not "realize that other sellers offer the same flights at a lower price because they are charging lower service fees or no fees at all." Order 2001-12-7, at 4. The Department should clarify that, as an initial matter, it intends for its new policy on service fees to be applicable to all travel agencies, and that it does not propose to establish a merely optional procedure for the disclosure of service fees, as some parties have suggested.

Most importantly, the Department should clarify exactly what will and will not be permitted in the way of service fee disclosure. Orbitz believes, as it has previously argued to the Department, that disclosure of agency service fees, as a price item which is not inherent in the price of the air transportation and varies from agency to agency, is in the interest of consumers. But a disclosure requirement, no matter how well-intentioned, still can result in disclosures that are confusing to consumers, inconsistent from agency to agency, likely to obfuscate useful information, or bound to result in other more useful information being omitted. Disclosures can be made in ways that are clear, consistent, not likely to obfuscate other information, and do not consume so much space that other useful information is forced off the page. The Department should focus on achieving the latter and not the former. The following suggestions are intended to assist in that effort.

The Department should require all airfare advertisements and solicitations either to include the agency service fee (with the fee separately disclosed), or it should require them all not to include the agency service fee (with the fee separately disclosed). The choice between these two alternatives should not be optional on an agency-by-agency basis. As a consumer switches from one agency to another, the basic rules of disclosure should be the same. A statement of an airfare should have the same meaning at each outlet.

If the Department concludes that a stated fare *must not* include the agency service fee, but that any additional service fee should be separately disclosed once in the same advertisement or solicitation, with respect to any airfares stated in that advertisement or solicitation, and, specifically, that before a consumer makes a purchase the airfare, the service fee, any other charges, and the total price are clearly itemized and totaled for the consumer, that would be effective disclosure, and Orbitz would support such a requirement.

If, in the alternative, the Department concludes that a stated fare *must* include any agency service fee, but that the service fee also should be separately disclosed once in the same advertisement or solicitation, with respect to any airfares stated in that advertisement or solicitation, and, specifically, that before a consumer makes a purchase the airfare, the service fee, any other charges, and the total price are clearly itemized and totaled for the consumer, that also would be effective disclosure, and Orbitz also would support such a requirement.

If, however, the Department were to require that at each point another airfare is stated in the same advertisement or solicitation (i.e., on the same web page), that any agency service fee be separately stated immediately adjacent to each additional airfare, that requirement would promote clutter more than clarity; would confuse rather than inform; and would force off the page flight options and other valuable information to consumers.

This distinction is very important to Orbitz and as well as to other online agencies that offer consumers a large number of airline, flight, schedule, and fare options on a single page. And it is important also to consumers, who need clarity and efficiency for disclosure to be helpful and welcome. In the case of a list of airfares on a web page, if the agency was required to append a notice to each fare in the list that stated, for example, "fare includes a $5 agency service fee," the result would be both cluttered and absurd. The results of a flight search on Orbitz often will display as many as 200 flight and fare options. To add a line to every one of those options in the flight display list that stated "fare includes a $5 agency service fee," and to repeat that statement up to 200 times throughout that display of flights and fares, would serve no good purpose, but would add enormous clutter. On the other hand, a requirement that at the top or the bottom of that list, a notice had to be displayed that informs consumers that "fares above (or below) include a $5 agency service fee" would serve a useful purpose, providing full disclosure to consumers without needlessly getting in their way.

A similar approach should apply to a listing of airfares on a website splash page, in a pop-up or banner advertisement on the Internet, in a newspaper ad, or a radio or television ad. A list of airfares should be required to be accompanied by not less than one disclosure (prominent and proximate to the list) that the fares listed either include, or do not include (as the Department may decide in this rulemaking) an agency service fee. But to continually repeat the same disclosure for each fare in the list will only result in less fare information being presented to the public, and will not improve disclosure. By the same token, an offline agency should not need to repeat to a customer on the telephone that each fare the agency quotes includes or does not include a service fee – after the first disclosure, such a practice would only waste both the consumer's and the agency's time, and provide no additional information to the consumer.

Instead, the agency simply could be required to disclose, when first quoting a fare, that all fares quoted include, or do not include, that agency's standard service fee.

In sum, the basic principle should be that each list of airfares should be accompanied by one disclosure with respect to agency service fees. That disclosure should be prominent and proximate to the list. As the Department has recognized, it should not adopt requirements that would discourage innovative methods of display, and thus limit the information made available to consumers, through unnecessary regulation. See 67 Fed. Reg. at 69412.

A second basic principle should be that before a consumer makes a final purchase, the agency should spell out the airfare, each additional cost item (such as separable taxes and fees, any agency service fee, trip insurance, etc.), and the total the price that the consumer will be charged.

In addition, the Department should clarify its definition of what agency service fees are required to be disclosed. Most offline agencies, for example, now offer consumers a menu of services, each of which can have its own separate fee. Online agencies likewise are increasingly offering a range of services and a range of fees. At the time a consumer begins to research flight and fares options, the agency does not know which of the many service and fee options the consumer subsequently will select. The agency could not possibly know, at the point fares first are quoted, what the full fee total will be.

Orbitz would suggest that, for purposes of disclosure at the point specific fare options are first presented to the consumer, the agency service fee that must be included or disclosed (as the Department may decide in this rulemaking) should be the least possible fee the consumer could pay to buy the listed air transportation from that agency. However, for the full protection of the consumer, prior to making a purchase commitment, the consumer also should be presented with an itemized and totaled list of all cost items, including airfare, separable taxes and fees, agency service fees, trip insurance fees, etc.

Most fundamentally, the Department should clearly spell out what it is requiring on each of these points. Consumers are best served when they can have a clear set of expectations, and agencies can best comply when they are able to know the rules of the road in advance. These are not questions that should be left to later ad hoc interpretation. That would not serve the interests of any party.

2) The $20/10% Proposal

The Department should delete from the proposed Part 399.84(b) the clause "if the fee exceeds the greater of $20 or ten percent of the price of air transportation, tour, or tour component." This clause has already caused a great deal of confusion – which is not a promising starting point for a consumer disclosure provision. The Department has only just attempted to diminish this confusion by issuing a clarification. See Notice of Proposed Rulemaking: Correction, 68 Fed. Reg. 12622 (March 17, 2003).

By one possible interpretation (which the Department in its correction has moved to dispel), this clause would cap the service fees that can be charged by travel agencies, and would in effect impose rate regulation on travel agencies. The rate regulation of service fees is, as a general matter, inconsistent with the economic deregulation of air transportation and the sale thereof, nor does the NPRM include any specific justification for such rate regulation.[26] Indeed, rate regulation is simply not an appropriate subject for Part 399.84, which was adopted under the

[26] The Department does suggest that travel agencies might inflate their service fees in order to make an advertised fare appear lower. 67 Fed. Reg. at 69418. But no empirical evidence is cited, and in any case, such cost-shifting already is prohibited by Part 399.80(f) and Part 399.84. See, e.g., Order 90-2-56 (advertisement for a tour package stating price of $49, plus $75 "casino" service fee, held to violate Part 399.84).

authority of Section 411 (49 U.S.C. § 41712) to protect consumers from deceptive practices, and not to impose price regulation. See 49 Fed. Reg. 49440 (Dec. 20, 1984). Orbitz notes that it currently charges only $5 per passenger, or $10 for multiple passengers, for most itineraries, so a $20/10% ceiling on service fees would not have a direct or foreseeable impact on Orbitz. But many other travel agencies currently charge fees in excess of $20, and there is no reason why they should not be permitted to continue to do so if their customers believe that they receive service equal to or greater than the fees charged for that service.

By the other possible interpretation, the Department would allow service fees over $20/10%, but would require a different kind of disclosure by agencies charging those higher fees. More accurately, no disclosure would be required at all. The Department's basic approach to agency service fees under the proposed rule is that the stated fare must be inclusive of the agency service fee, and must be accompanied by a disclosure to consumers that the inclusive amount includes a specified amount of agency service fee. However, by this interpretation, if the service fee is over $20, then it need not – and indeed, must not – be disclosed separately. In other words, a *smaller* service fee must be disclosed separately in addition to being included in the stated price, but a *larger* service fee need not be disclosed separately and need only be included in the stated price. As a result, the larger the service fee, the less disclosure that is required. That cannot be in the interests of consumers. If anything, the larger a service fee, the more important its disclosure. Furthermore, this approach would violate the basic objective of having the principles of disclosure be consistent with respect to all agencies, so that consumers are not confused as they compare one outlet with another.

Whichever interpretation applies, the Department should delete this clause from its proposal before making the proposal final.

B. The Effective Date of the Revised CRS Rules

All changes recommended herein should take effect 30 days after the publication of the revised rules in the Federal Register, as is standard practice, except as specifically noted above with regard to certain subscriber contract provisions.

C. Technical Corrections

Orbitz notes that despite the thorough and extensive work the Department put into preparing the NPRM, a few errors and inconsistencies still can be found in the proposed revised text of Part 255. In the interests of making a good proposal even better, Orbitz has attached as Appendix E a list of proposed technical corrections to Part 255.

* * * *

Respectfully submitted,

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Dated: March 17, 2003

Appendix A

U.S. Department of Transportation

Office of the Secretary of Transportation

400 Seventh St., S.W.
Washington, D.C. 20590

April 13, 2001

Mr. Jeffrey G. Katz
Chairman, President, and Chief Executive Officer
Orbitz
200 South Wacker Drive
Suite 1900
Chicago, IL 60606

Dear Mr. Katz:

The Department of Transportation has thoroughly examined a number of concerns and allegations raised about Orbitz by members of Congress, state government officials, traditional and online travel agents, computer reservation systems, some airlines, and others. The Department has taken this action because Orbitz, an online travel agency, is currently owned by five major airlines. The purpose of this letter is to inform you of the status of our informal investigation to date by outlining our findings on whether Orbitz's ownership and management structure, technical and business plans, and proposed operating procedures warrant action under 49 U.S.C. 41712.

The Department has concluded that it should neither block Orbitz from beginning operations nor compel it to change its business strategy at this time, but that the Department should review the implementation of Orbitz's business plans after its launch. We are requiring Orbitz to submit a report six months after the date of its official launch relating to the specifics of its actions in the marketplace. We will also monitor Orbitz's behavior with respect to a number of issues of concern that are addressed in more detail below.

The antitrust related issues have arisen because Orbitz is owned by five major airlines and because Orbitz plans to offer airlines rebates on certain fees if they agree to become "charter associates." A charter associate must agree to a most favored nation (MFN) clause requiring the airline to make available to Orbitz all of its publicly available fares, subject to certain conditions. The charter associate agreement raises a number of concerns, one of which is the implementation of the MFN clause. Although the charter associate agreement expressly permits airlines to provide equivalent fares and special offers to Orbitz's competitors, the question remains whether Orbitz substantially reduces charter associate carriers' incentives to make their lowest fares (including webfares) available through other online travel agencies, even if these agencies match the terms offered by Orbitz. We would be concerned if such activity occurred and we will monitor developments closely. However, based on our analysis of Orbitz's documentation and business plan, we do not have sufficient evidence to conclude that Orbitz's charter associates will engage in this type of behavior

The decision to revisit the effects of the transaction after it is operational is consistent with the Federal Trade Commission's decision on Covisint, the business-to-business exchange being developed by the largest U.S. automobile manufacturers and two foreign manufacturers. The FTC decided that it would not stop the manufacturers from creating Covisint but, as we are doing here, it reserved the right to take further action in the future if required by the public interest.

While the antitrust laws allow competitors to establish joint ventures that provide efficiencies and do not unnecessarily restrict competition, joint ventures do raise the possibility for collusion and unreasonable restrictions on competition. For this reason, the Department concluded that it should investigate whether Orbitz's creation and business plan could involve anticompetitive practices prohibited by 49 U.S.C. 41712, formerly section 411 of the Federal Aviation Act, which authorizes the Department to prevent unfair methods of competition by airlines and travel agents. That provision allows the Department to prevent practices that violate the antitrust laws or antitrust principles, but it does not otherwise allow the Department to regulate airlines and travel agencies in an effort to improve competition or make it fairer. The Department's authority and the process in which it is exercised are different from those of the Department of Justice which is also investigating the joint venture. Our assessment of Orbitz was, however, informed by the *Antitrust Guidelines for Collaborations Among Competitors* (developed by the Department of Justice and the Federal Trade Commission) and existing case law, which emphasize rule of reason analysis in evaluating joint ventures. The *Guidelines* note that "the competitive effects of a relevant agreement may change over time, depending on changes in the circumstances such as internal reorganization, adoption of new agreements as part of the collaboration, addition or departure of participants, new market conditions, or changes in market share."

The Office of Aviation and International Affairs and the Office of the General Counsel jointly obtained information and documents on Orbitz, discussed the issues with all interested parties, discussed the proposed technical architecture of the website and Orbitz's business plan with Orbitz officials and staff members, and examined the Orbitz venture in the broader context of trends in airline marketing and distribution practices and e-commerce. Like all other parties to this issue, you and your staff have been very responsive to our requests for information, and we would like to thank you for your cooperation.

The Department's informal investigation focused on antitrust related issues, in particular whether Orbitz may be used as a vehicle for price/service collusion and coordination and whether the terms of participation in Orbitz may unreasonably restrict competition in the airline and airline distribution businesses. Our examination included three primary areas of concern that we address in turn below.

<u>Potential for Collusion and Coordination</u>

Our first concern is whether the owner (and charter associate) carriers could use Orbitz as a vehicle for price and/or service collusion or coordination and thereby reduce competition. Orbitz could increase the likelihood of collusion or tacit coordination if it enabled carriers to collect and share fare information in a manner not now available through any other means. Our examination of whether Orbitz might become a vehicle for price collusion or coordination has therefore focused on the technological architecture employed by Orbitz and procedures for its use.

We have established that the source of Orbitz's fare and schedule information is the same as that for all computer reservation systems (CRSs) -- the industry standard fare filings with the Airline Tariff Publishing Company (ATPCO). Orbitz thus creates no new mechanism for the filing and exchange of published fare information which is not already standard industry practice. Since Orbitz will not sell unpublished fares (which are therefore not governed by the charter associate agreement), it will not be a new vehicle for the exchange of information on unpublished fares, such as special corporate or travel agency fares. Webfares currently available only on charter associates' proprietary websites that will be sold through Orbitz will be filed through ATPCO with what is commonly known in the industry as a Category 15 restriction. This restriction designates that the fare is only available for sale through certain distribution outlets. This practice has for some time been very common in the industry. It is used to file negotiated fares and/or discounts (between an airline and a travel agency or between an airline and a corporation) in order to restrict access to those fares in accordance with the terms of specific commercial agreements.

Based on the evidence available to date, we cannot conclude that Orbitz will operate in ways that will reduce price competition or the availability of fares by making more information on services and fares available to airlines. The majority of airline fares and availability are already displayed on a real-time basis in CRS systems. Airlines also have access to booking and billing data from CRS systems for travel agent bookings. With new technologies for quickly and efficiently obtaining information on all published fares, including webfares, carriers can already monitor competitive responses through various web channels, and they do. Orbitz does not appear to uniquely facilitate such activities, but how this will play out in practice in the online environment remains to be seen.

The Charter Associate Agreement

The second of our three major concerns is whether the Orbitz arrangement may unduly restrict the airline charter associates' ability to distribute their services due to the MFN clause. Orbitz has represented that charter associate participation in Orbitz is open to all airlines and all airlines have been offered the same business proposition. Orbitz has further represented that it is not demanding that charter associates give it exclusive access to any fares or deny other online agencies the ability to sell any fares. In a letter to Secretary Mineta dated January 29, 2001, Orbitz states:

> The agreement does not prevent the carrier from also selling all of the fares it gives to Orbitz anywhere else on the Internet. It is expressly non-exclusive. In addition, under the terms of the agreement, if a competitor offers to undercut Orbitz' lower distribution costs in return for an airline offering an exclusive fare on that competitor's site, Orbitz must match the terms of the offer in order to also sell that fare. If Orbitz does not or cannot match, the MFN obligation does not apply. Accordingly, the terms of Orbitz' MFN clause protect competition and indeed may spark a 'race to the bottom' of lowered distribution costs – precisely the kind of efficiency competition should stimulate.

Critics argue that the MFN clause undermines the ability of individual airlines to make clandestine deals with other internet travel sites – deals that they rightly contend have a pro-competitive effect on airline pricing. This concern is somewhat lessened, however, by the fact that the MFN clause covers only published fares. Orbitz claims that the vast majority of "special deals" between airlines and online travel agencies involve unpublished fares outside the scope of the MFN, such as corporate fares, tour operator fares, off-tariff fares, group fares, meeting and incentive fares, opaque fares, and private fares. While this may be true, some of these "special deals" indeed involve published net fares which may be covered by the MFN contract. Thus, there is some potential impact on the market dynamic.

There may be mitigating factors to this impact, however. First, other agencies are free to match the terms of the Orbitz contract. In addition, the MFN agreement itself appears to provide some flexibility for charter associates which may ameliorate potentially anticompetitive effects on the market dynamic. For example, the MFN "does not obligate Airline to delay or forego a commercial opportunity due to Company's [Orbitz's] inability to proceed with a similar commercial transaction with Airline for technical, financial, or other reasons." Furthermore, Orbitz is contractually bound to being unbiased. It is committed on the record to not providing advertising for any "preferred carrier" which pays for such displays along the air booking path. If a competing online agency offers to sell air carrier advertising in the air booking path or offers some other form of "presence bias," the MFN clause is inapplicable according to Orbitz's documentation. Further, if a competitor offers the airline faster or better technology or price terms that Orbitz cannot match, the airline has no obligation to "delay or forego" the deal. Essentially, it is our understanding that if Orbitz cannot match the deal, it does not get it. Many of the "special deals" commonly negotiated between airlines and online travel agencies may therefore not be covered by the MFN clause. In sum, this provision of the MFN, the limitations on the types of fares covered by the MFN, and the fact that many carriers have not become charter associates may mitigate the negative impact on the negotiation dynamics in the market and the effect it may have on price or innovation.

The question is then whether any potential negative impact on competition outweighs the potential benefits of Orbitz. While we cannot predict market developments with certainty, at this point in Orbitz's development, it is possible that the benefits potentially offered by Orbitz may outweigh any harm from the MFN clause. Orbitz is currently in a beta test, has made few sales, and has virtually no market share. Orbitz has represented that the MFN clause was, in fact, designed "to facilitate entry by a small player without market share in the face of existing, entrenched competitors and thereby lower distribution costs." Even with the backing of the airline owners, Orbitz faces substantial hurdles in a tough, thin-margin business. The existing online agencies, unlike Orbitz, already have substantial experience in meeting consumer needs and offer a complete range of travel information and services. It will be difficult and costly for Orbitz to match the large number of features and the range of travel services that other online agencies have already developed through several years of experience. Given that other online agencies are not owned by airlines, they may have an advantage in that many consumers prefer what they perceive as impartial sources of information. Perhaps more significantly, the major online agencies have exclusive arrangements with the major internet portals (such as Yahoo!, AOL, MSN, Excite@Home, and others), which can drive up the cost of customer acquisition for new entrants.

To the extent that the MFN clause enables a new entrant to gain a foothold in a marketplace dominated by two incumbents, it may lead to substantial consumer benefits by establishing another major competitor in the comprehensive online travel agency marketplace. These benefits may outweigh attendant disadvantages. It is impossible to predict with certainty what will happen in the marketplace, but we believe that market forces should be allowed to operate unless and until there is a demonstrated need for government intervention. We do not want to pre-empt potentially pro-competitive market forces.

According to Orbitz, if airlines choose not to sign a charter associate agreement, "Orbitz will nevertheless display their fares in its unbiased search results and sell their services, just as it does the Charter Associates. However, only Charter Associates receive a discount on the cost of selling their fares through Orbitz." Furthermore, Orbitz states:

> ...without the MFN clause, which confers on Orbitz a marketing advantage of comprehensive inventory, Orbitz would have an incentive to join the current oligopoly CRS pricing for booking fees rather than compete with it. The 'pressure' on airlines to accept Orbitz' offer is nothing more than an opportunity to escape the high cost of CRS booking fees while displaying its fares on a site with national reach, and the fact that if it does not, its competitors may.

In addition to examining the MFN clause and related issues, we have examined the charter associate agreement provision that requires associate carriers to provide in-kind marketing support to facilitate Orbitz's marketing and consumer awareness. Charter associates can choose a variety of in-kind contributions (from using Orbitz's cups and napkins to providing affinity program supplements to Orbitz users). The Department has examined two issues. The first is whether the method of calculation for the amount of in-kind promotions due Orbitz discriminates against small carriers by placing a greater burden of marketing support (in-kind promotions) on the smaller or low-fare carriers. We conclude that, based on estimates for the first year, the application of the formula to determine the dollar value of in-kind support (which is based on total share of domestic traffic) should not be discriminatory. The Department notes, however, that the charter associate contract provides for the parties to determine the timing and value of each in-kind promotion by mutual agreement. The Department will review whether the in-kind promotional marketing agreements are implemented in a discriminatory fashion.

The second in-kind promotion support issue investigated by the Department is the provision allowing an airline to get a limited amount of credit each year (toward its in-kind promotional support obligation) if it offers special fares exclusively to Orbitz, or only to Orbitz and the airline's own website. Orbitz has assured us that charter associate airlines have sole discretion over the selection of methods to meet their in-kind promotional obligations and they are free to fulfill their in-kind contributions entirely by other methods. According to Orbitz's documentation, "The maximum amount of credit that an airline can get through this option is set at a low, fixed number; even if revenues from the fare promotion were to exceed that limit, it would not further reduce the airline's in-kind obligation." Furthermore, this in-kind promotion method "...cannot under any circumstances fulfill more than half of its in-kind obligation...." Nevertheless, we have serious concerns about incentives toward exclusivity, however limited. While we are prepared to reserve judgment until we see how this provision operates in the marketplace, we will monitor these developments closely. Allowing a new entrant with no sales or market share to offer financial incentives to get exclusive access to a very limited portion of supplier inventory may be a legitimate means of overcoming entry barriers.

We therefore conclude that the evidence does not justify prohibiting the Orbitz MFN agreement at this stage, but we will closely monitor its effect on the marketplace once Orbitz launches. The Department has ample authority to take action if it should be warranted based upon actual activity in the marketplace, rather than conjecture prior to Orbitz's start-up.

Orbitz's Potential Position in the Online Agency Business

The third primary issue we investigated was whether Orbitz, due to its airline ties and MFN clause, would reduce competition among online agencies by quickly attaining a dominant position in the online agency business, thereby causing such irreparable harm as to warrant prevention of its launch. We have decided not to intervene at this time for three primary reasons: 1) the incumbent online travel agencies enjoy a significant "first mover advantage" and have far more experience in dealing with the online environment, and they continue to bring innovations to the market to compete and differentiate themselves; 2) many carriers (including a number of low-fare carriers) have decided not to become Orbitz charter associates, which means that Orbitz cannot claim to be a one-stop shop for the lowest fares; and 3) even Orbitz owner and charter associate carriers have a strong economic interest in minimizing distribution costs by serving customers through their own websites (thereby exerting a natural counterbalance) and are therefore less likely to market through Orbitz in a monolithic way. Though airlines want to drive as much of their total sales as possible through the internet to reduce costs, their ability to channel traffic seems to be limited, and carriers have generally sought to be present in as many internet distribution channels as possible. Southwest, moreover, will not participate in Orbitz as a charter associate. Without Southwest and without the willingness of other airlines to agree to the MFN clause, Orbitz cannot hold itself out as the site that offers every airline's lowest fares or as the only site that consumers need to visit.

The distribution of travel services is undergoing radical change through innovation. New products of all sorts are being developed which have great potential. Some of the many projects underway are websites which will build the first airline ticket exchange place where individuals and airlines alike can buy and sell tickets. Other sites apply screen-scraper technology to automatically read the screens of others (airline websites, online agencies, etc.) and report those findings to customers. Sidestep, for example, has developed technology that connects disparate, dynamic information sources in real time, which allows consumers to find the best travel deals, and then directs them to the vendor's site for purchase (collecting a referral fee from the vendor). Despite these changes, however, no one is predicting that travel agents will stop accounting for most bookings industry-wide in the foreseeable future. At the advent of the internet age, many predicted that the traditional travel agent would become obsolete. Now, many of the same observers focus on the value and critical importance of the individual human travel professional in the success of the very internet travel sites that were previously viewed as rendering them obsolete. Online agencies are now hiring substantial numbers of people to provide such interactive customer service, while other innovations such as eGulliver have created new opportunities for travel agents. In short, the distribution market is still very fluid and no one can predict how it will evolve. We believe the government should not hinder innovation unless and until there is sufficient evidence of anticompetitive conduct.

We recognize that Orbitz is likely to have access to fares offered by charter associates that are not available to other online agencies. We do not believe, however, that it is appropriate at this time to require airlines to sell their webfares through all travel agents, online and offline. It is important to keep in mind that normal published fares, which account for most bookings made through the internet, are made available months in advance and typically through all channels. Weekend webfares, however, reportedly account for less than one tenth of 1% of the fares an airline offers, and are normally made available only a few days before flight time, and only on flights which have an unusually high number of empty seats. Webfares are only rarely available in most markets, are not predictable, and are offered at prices so low that airlines typically want to distribute them through the lowest cost channels possible. In addition, travel agents can book webfares off an airline's website for a customer if they wish, although the relevant airline decides whether the travel agent receives a commission on these bookings.

Even before the advent of the Internet, airlines did not treat all distribution outlets the same with respect to the fares that they are authorized to sell. Travel suppliers have long used consolidators to sell seats at low fares not available to travel agencies and airline reservations agents. Airlines commonly give favored travel agencies specific access to discount fares and marketing benefits and enable favored agencies to waive some restrictions on discount fares and to book customers on oversold flights. Requiring carriers to distribute all fares through all channels might, in fact, decrease competition in the distribution supply chain. The Department has interpreted the aviation statutes as allowing airlines the same degree of flexibility in deciding how and through what retail channels to sell their services as producers in other industries have, consistent with antitrust principles.

Orbitz as a New Competitor

Our conclusion not to take action to require modifications of the MFN clause at this stage reflects the inherent desirability of having new entry in the comprehensive online travel agency business and having as much competition in the marketplace as possible to maximize consumer welfare. New entry is particularly attractive in light of the trend toward mergers and acquisitions among online travel agencies. Orbitz will introduce new competition in the online agency business. Like any other entrant into the online agency business, Orbitz must develop features offsetting the existing agencies' competitive advantages: their greater experience and brand recognition, their complete range of travel information and services, and their exclusive arrangements with major internet portals. The advantages offered by its technology and business plan may enable Orbitz to become a major competitor. The comprehensive online agency business seems unlikely to attract much new entry. No online travel agency is profitable, though both Travelocity and Expedia expect to reach profitability soon. This reflects the enormous investments inherent in the industry and its thin margins – even with the institutionalized technological support of powerful parent companies like Sabre and Microsoft. We cannot know if Orbitz will be successful. Orbitz has obtained substantial capital investments from its airline owners and expects to raise additional capital from other sources. The willingness of airlines and non-airlines to invest capital presumably reflects their judgment that Orbitz can succeed.

Forrester Research, an internet consulting firm, believes that after Orbitz there will be no new comprehensive travel sites due to the investment required to launch them, the tightening venture capital markets, the low margins involved in the business, and the dominance of the two major players, all of which constitute barriers to entry. Airline distribution was computerized even before the internet age, which facilitated its early debut in the online environment. But the more advanced internet technology is now dependent on much older CRS and airline technology. Orbitz has spurred competition by re-engineering these older technologies with which the customer does not directly interact (and which therefore do not directly enhance a website's appeal to the customer). Prior to Orbitz, investment largely (though not exclusively) concentrated on technologies with which the customer does directly interact – thereby enhancing a website's consumer appeal and market share. Orbitz may therefore spur greater innovation in the "back office," which ultimately will benefit both suppliers and consumers.

We also recognize that Orbitz's approach could potentially add a new element to competition among distribution outlets. We have observed that some online agencies offer airlines preferred supplier agreements to increase an airline's revenue stream from that agency by creating some form of enhanced presence on the pages of the website. While such agreements may be positive in that they encourage carriers to offer promotions and fare sales that might otherwise not be offered, some consumer groups have expressed concern that such preferred supplier relationships may spill over into what are otherwise considered to be neutral flight displays. The display of ads in the booking path and the prominent feature of buttons triggering exclusive displays of preferred carrier flights have been cited by some observers as examples of such forms of prejudicial behavior. Orbitz's commitment to an unbiased display could therefore have a positive effect by offering services many customers may prefer.

Airline Distribution and the Internet

Clearly, the Orbitz controversy does not exist in a vacuum but is inextricably related to other issues concerning the rapid development in the use of the internet for the distribution of air travel, including the changes that it has caused for travel agents. Although Orbitz has been a lightening rod of sorts in the public policy debate on these issues, many of the concerns raised – about consumer protection through adequate disclosure on travel websites, the role of intermediaries and "neutral" sources of information in consumer choice, and so forth – are not exclusive to Orbitz. The Department believes that these issues should be addressed in the current CRS rulemaking. We are examining how the current CRS rules should be changed and whether, and to what extent, they should cover any internet activities. (The CRS rules currently do not cover online – or any other – travel agency activities.) As an online travel agency, Orbitz would be bound by any rules adopted by the Department for internet sales of air transportation.

While we have thus thoroughly reviewed the relevant information to date on the Orbitz business and operating plans, we fully recognize that the implementation of those plans may give rise to competitive concerns. Government intervention in the marketplace should, however, be designed to correct a failure of market forces, not to replace or pre-empt them. We do not accept the argument that, once Orbitz launches, any anticompetitive conduct cannot be corrected or prohibited. If the implementation of Orbitz's structure and business arrangements later present a threat to competition in the airline or travel distribution businesses, the Department can take action at that time. Based on our review of Orbitz's current technical architecture and business and operating plans, there is insufficient evidence to conclude that the joint venture is *ipso facto* anticompetitive and that its launch should be prevented.

While we do have lingering concerns that Orbitz may *operate* in ways which might be anticompetitive and will monitor those concerns after launch, we find that the present terms of participation do not warrant Department intervention at this stage. We request that you report back to us within six months from the date of official launch to review the implementation of the business model, noting in particular and in detail any deviations from the plans, policies, and procedures examined by us.

Sincerely,

Susan McDermott

Susan McDermott
Deputy Assistant Secretary for
Aviation and International Affairs

Samuel Podberesky
Assistant General Counsel for
Aviation Enforcement and Proceedings

Appendix B

REPORT TO CONGRESS

EFFORTS TO MONITOR ORBITZ

June 27, 2002

Report of the Office of Aviation & International Affairs
Pursuant to U.S. Department of Transportation
Appropriations for FY 2002 Conference Report
House Report No. 107-308

EXECUTIVE SUMMARY

In the spring of 2001, the Department conducted an informal investigation of Orbitz, the online travel agency owned by five large U.S. airlines (American Airlines, Continental Airlines, Delta Air Lines, Northwest Airlines and United Air Lines), to see whether Orbitz's ownership and management structure, technical and business plans, and proposed operating procedures warranted action under 49 U.S.C. 41712 of the Department's organic statute giving it the authority to prohibit airlines and travel agencies from engaging in unfair methods of competition. We were concerned that Orbitz's airline ownership and its use of a "Most Favored Nation" (MFN) clause in agreements with airline participants could lead to a reduction in competition in the airline and airline distribution businesses. Furthermore, we were concerned that the owner carriers and other carriers participating in Orbitz could use it as a vehicle for price and/or service collusion or coordination and thereby reduce competition.

After a review of available information on Orbitz's business and operating plans, the Department determined that there was insufficient evidence to conclude that the joint venture was *ipso facto* anticompetitive and that its launch should be prevented. However, the Department planned to review the impact of Orbitz's actual operations on competition, rather than relying on unrealized business plans in making a definitive determination. The Conference Committee Report on the DOT appropriations bill for fiscal year 2002 requests that the Office of Aviation and International Affairs "report on its monitoring efforts" of air travel services related to Orbitz as a "joint airline distribution venture."

In conducting its informal investigation, the Department has had extensive discussions with Orbitz, online travel agencies, global distribution systems, and airlines which own or participate in Orbitz as charter associates as well as those who do not. The Department also issued extensive requests for information and documents from selected parties.

The Department refrains from reaching definitive conclusions in this report because the Department of Justice has not completed its antitrust review of Orbitz. The Department of Transportation and the Department of Justice will continue to coordinate the completion of our separate, independent investigations of Orbitz.

In this report, the Department addresses four primary concerns identified by the Conferees: 1) deviations from plans, policies, and procedures initially proposed in the joint venture's business plan and contained in its charter associate agreements; 2) the extent to which the joint venture has adhered to its commitment to not bias displays of fares or services; 3) the extent to which ties between the airline-owners and the "Most Favored Nation"clause in the charter associate agreement have resulted in monopolistic or other anti-competitive market behavior; and, 4) whether airline-owners of the joint ventures or charter associates have acted in an anti-competitive manner by choosing not to distribute fares through other on-line distribution outlets.

Based on information reviewed to date, Orbitz's implementation has been generally consistent with plans, including its filing for an initial public stock offering. One notable exception is that, since September 11, 2001, Orbitz has not received any additional funding from its airline owners.

Based on all evidence reviewed to date, Orbitz has also adhered to its contractual commitment to unbiased presentation of airline services which prevents Orbitz from accepting traffic-share shifting override commissions from airlines and from engaging in preferred carrier relationships like other online agencies. Orbitz therefore continues to view the MFN provision as a key part of its strategic position in a competitive online travel agency marketplace that is also important to supporting Orbitz's role as technology developer and provider. Orbitz is developing direct connection to the airlines' internal reservation systems to reduce airline dependence on expensive GDSs (global distribution systems or CRSs, computer reservation systems) and to significantly lower distribution costs.

Orbitz's competitors charge that, whether or not it is being invoked directly, the MFN clause has had a significant effect on how Orbitz charter associates offer and sell their inventory. They argue that airlines are sensitive to the broad dissemination of discounted published webfares and when they are required to sell such discounted fares on Orbitz as well as its own website in all cases, the carrier is more reluctant to further increase the dissemination of these fares on other websites. While some airlines agree that the MFN has affected how they distribute their inventory, more airlines argue that the MFN has not had such an impact. In addition, in recent months several Orbitz charter associates have reached agreements with major online agencies, some of which involve some level of access to webfares. The Department has obtained confidential information about the terms of these agreements.

Many airlines now view the primary purposes of webfares as a tool to induce consumers to use low-cost channels of distribution and thereby reduce distribution costs. Many carriers have averred a willingness to expand the availability of webfares to all channels prepared to offer them long-term, low-cost distribution economics and are using webfares as an inducement to obtaining such commitments from a variety of distribution channels. Webfares are substantially more prevalent in the marketplace than they were in May 2001. However, the percentage of tickets sold at webfares is highly variable and dependent on a number of market and carrier-specific conditions. PhoCusWright recently reported that webfares represent less than 2% of an airline's total ticket sales. It is unclear whether the number of webfare tickets sold as a percentage of total tickets will change.

Even before the advent of the Internet, airlines did not treat all distribution outlets the same with respect to the fares they are authorized to sell. The Department has traditionally interpreted the aviation statutes as allowing airlines the same degree of flexibility in deciding how and through what channels to sell their services as producers in other industries have, consistent with antitrust principles.

Reaching definitive conclusions on the impact of Orbitz on competition in the airline and airline distribution businesses is complicated by the fact that both the airline and the online travel agency businesses are changing very rapidly. Businesses in both sectors are fundamentally re-evaluating both the revenue and the cost sides of their businesses. The online travel distribution market is therefore still very fluid and no one can predict how it will evolve. By its very existence as part of a new and integrated business model, the Orbitz MFN has clearly affected the marketplace. The challenge for DOT is to definitively determine its effect on the marketplace in light of antitrust laws and antitrust principles. To date, Orbitz has had some pro-competitive effects in the marketplace and has brought some benefits to consumers. Orbitz could, however, evolve in ways that could harm airline competition and the potential for concern still exists. In particular, the Department is concerned about the potential that the Orbitz MFN could discourage selective discounting and other direct marketing initiatives through various distribution channels. However, government intervention in the marketplace should be designed to correct a failure of market forces, not to replace or pre-empt them in ways that could potentially stifle innovation.

Background

In the spring of 2001, the Department conducted an informal investigation of Orbitz, the online travel agency owned by five large U.S. airlines (American Airlines, Continental Airlines, Delta Air Lines, Northwest Airlines and United Air Lines), to see whether Orbitz's ownership and management structure and technical and business plans could lead to a reduction in competition in the airline and airline distribution businesses. Furthermore, we were concerned that the owner carriers and other carriers participating in Orbitz could use it as a vehicle for price and/or service collusion or coordination and thereby reduce competition.

The basis for this informal investigation is 49 U.S.C. 41712, formerly section 411 of the Federal Aviation Act. That section authorizes the Department to prohibit unfair methods of competition by airlines or travel agencies "in air transportation or the sale of air transportation."

On April 13, 2001, the Department issued a public letter to Orbitz outlining the status of our informal investigation. After a review of available information on Orbitz's business and operating plans, we determined that there was insufficient evidence to conclude that the joint venture was *ipso facto* anticompetitive and that its launch should be prevented. However, we said we would review the impact of Orbitz's actual operations on competition, rather than relying on unrealized business plans in making a definitive determination. We also requested that Orbitz report back to us within six months from the date of official launch so we could review the implementation of its business model. On November 15, 2001, Orbitz submitted its six-month report to the Department.

Separately, on May 16, 2002, the Secretary announced the establishment of the National Commission to Ensure Consumer Information and Choice in the Airline Industry which was created by the Aviation Investment and Reform Act for the 21st Century (AIR-21) to study the market position and general condition of retain travel agents in today's competitive markets for the sale of air travel service.

The Conference Committee Report on the DOT appropriations bill for fiscal year 2002 (House Report 107-308) requests that the Office of Aviation and International Affairs "report on its monitoring efforts" of air travel services related to Orbitz as a "joint airline distribution venture" and to report our findings to the Department's Inspector General.[1]

Scope of the Report

This report on the monitoring efforts concerning Orbitz by the Office of Aviation and International Affairs addresses the following potential concerns outlined by the conferees:

- Deviations from plans, policies, and procedures initially proposed in the joint venture's business plan and contained in its charter associate agreements;
- The extent to which the joint venture has adhered to its commitment to not bias displays of fares or services;
- The extent to which ties between the airline-owners and the "Most Favored Nation" clause in the charter agreement have resulted in monopolistic or other anti-competitive market behavior; and,
- Whether airline-owners of the joint ventures or charter associates have acted in an anti-competitive manner by choosing not to distribute fares through other online distribution outlets.

[1] House Report No. 107-308.

Monitoring Activities

The Department seeks to determine whether the terms of participation in Orbitz are unreasonably restricting competition in the airline and airline distribution businesses. To undertake this task, we obtained additional information from various parties.

The Department has had a series of conference calls with selected smaller carriers, both those with charter associate relationships with Orbitz (discussed below) and non-charter associates. Included in the latter group have been some of Orbitz's most ardent airline skeptics.

In addition, the Department has conducted numerous discussions with online travel agencies, global distribution systems (GDSs, also known as computer reservation systems or CRSs), and travel agencies that have expressed concerns about Orbitz's impact on the airline and airline distribution businesses.

From February 28 to March 1, 2002, Department staff visited the Chicago headquarters of Orbitz and conducted extensive discussions with Orbitz officers about the implementation of Orbitz's technological and business plans, updating the information obtained during a similar discussion prior to Orbitz's launch.

On March 12, 2002, the Department issued extensive requests for information and documents from Orbitz, from all of Orbitz's owner airlines, from selected non-owner airline charter associates, and from selected major online travel agencies. Additional online agencies have voluntarily submitted their points of view to the Department.

The information the Department requested involves confidential business information. We have, for example, asked for information on business plans, contracts, and proprietary data. The information contained in the reports is confidential, privileged, and proprietary information whose release to the public would likely cause the submitting company substantial competitive harm and that is not customarily disclosed to the public.

All respondents have asked for confidential treatment under our rules, 14 C.F.R. 302.12, and the Department has given the respondents every assurance that we will use our best efforts to protect the confidentiality of all sensitive business information submitted pursuant to its request. We therefore intend to withhold such confidential information from release under the Freedom of Information Act (FOIA), which authorizes agencies to withhold trade secrets and commercial or financial information that is privileged or confidential.[2] Federal law provides other protection for confidential business information.[3] Also, two Federal statutes apply that involve FOIA's Exemption 3, for statutes outside FOIA that authorize withholding of information. These are 49 U.S.C. 40115, which protects the competitive position of U.S. air carriers engaged in international operations (which the Orbitz owners do), and 49 U.S.C. 46311, which protects information gathered from air carrier records. The ability of the Department to effectively conduct such informal investigations is dependent upon our ability to protect the confidentiality of sensitive business information requested by the Department. The Department very much appreciates the understanding that Congress and others have shown in this regard.

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[2] 5 U.S.C. 552(b)(4).

[3] See 18 U.S.C. 1905.

Pending Cases and Investigations

The Department of Justice has an open investigation of Orbitz and has not reached a final determination in this case. The Department of Transportation continues to consult with the Justice Department.

On March 28, 2002, the American Society of Travel Agents and Hillside Travel, Inc. submitted to the DOT a formal complaint (OST Docket 2002-12004) against Delta Air Lines, Inc., United Air Lines, Inc., American Airlines, Inc., Northwest Airlines, Inc., Continental Airlines, Inc., US Airways, Inc., America West Airlines, Inc., Air Canada, and Orbitz LLC for unfair practices and unfair methods of competition in air transportation and the sale of air transportation, in violation of 49 U.S.C. 41712, and requested that the Secretary of Transportation order these airlines and Orbitz to stop their alleged unlawful practices. ASTA and the agency allege that the airlines' unwillingness to allow all travel agencies to sell webfares is an unfair method of competition when combined with their elimination of base commissions.

Developments in the distribution of air travel over the Internet are extremely fluid. A variety of innovations, mergers and acquisitions, and changes in the corporate strategies of suppliers and distributors are likely to significantly affect the competitive dynamic in the airline distribution business. The Department of Transportation and the Department of Justice will coordinate the completion of our separate, independent investigations of Orbitz. The Department will therefore refrain from reaching definitive conclusions in this report. However, the Department can fulfill the Conference Report request to report on our monitoring efforts to date. After a brief introduction to Orbitz in the context of trends in online travel distribution, each concern will be addressed in turn.

Orbitz in Context

Five general types of business-to-consumer travel sites can be identified on the Internet: the airlines' own websites, GDS-based online travel agencies (sites such as Travelocity, Expedia and now Orbitz), "opaque" sites[4] (sites that ask customers to bid for tickets and pay for bookings before knowing the airline and/or schedule), specialty low-fare sites (these are more like tip sheets for selected bargains, sometimes just for airfares or other elements of a trip) and "screen-scraper sites" (sites that may or may not have direct data link access to the offerings of airlines, but use technology that automatically reads the screens of other travel websites and reports those findings to the customer).

At the most basic level, Orbitz can be viewed as similar to any online travel agency. Orbitz uses new technology to search schedules and fares directly from airline filings with the Airline Tariff Publishing Company (ATPCO) and currently uses the Worldspan GDS as a booking engine. The joint airline website largely replicates the airline booking services already offered by online agencies, a market in which Travelocity and Expedia are the primary incumbent players with over 60% of online agency bookings, both prior to Orbitz's launch and today.

Orbitz is, however, different from other online agencies in three principal respects:

[4] An opaque fare is an unpublished fare sold via the Internet in a manner such that airline identity, time of departure/arrival, and duration/routing of trip are not disclosed until after the consumer makes a purchase.

Ownership: The five largest U.S. carriers—United, American, Delta, Northwest, and Continental, which account for over three quarters of scheduled U.S. airline industry revenues, created and own Orbitz.[5]

Fare Offerings: All airline services which are available for sale in Worldspan are also available for sale in Orbitz. As a precondition to the formation of Orbitz, the airline owners agreed to sign a charter associate agreement whereby the airline agrees to sell all of its published fares (including special webfares sold on its own website and on third party websites) through Orbitz on a non-exclusive MFN (most favored nation) basis. Orbitz will rebate to the charter associate airlines part of the booking fees directly back to the airline. Worldspan often gives its large travel agency customers like Orbitz a portion of the booking fees obtained by Worldspan from airlines and Orbitz thus shares with the charter associate airlines the fees remitted by Worldspan to Orbitz. The MFN clause does not apply to unpublished fares such as corporate fares, tour operator fares, off-tariff fares, group fares, meeting and incentive fares, and private fares. While the MFN clause does not prohibit charter associate airlines from offering particular published fares on third-party travel provider websites, Orbitz must be given the opportunity to match the terms for access to those fares, if it is able to do so. Orbitz has offered the same commercial terms to non-owner airlines who wish to become charter associates. Each owner and non-owner charter associate airline must also provide some in-kind marketing assistance for Orbitz, based on its relative market share, with the maximum amount capped at a fixed level. Orbitz's owners have all agreed to these same provisions. Some non-owner airlines have opted to become charter associates. Others have not, most notably Southwest Airlines. A list of Orbitz charter associate carriers is provided in the Appendix.

Contractual Commitment to Neutral Displays and the Reduction of Distribution Costs: Orbitz maintains it is contractually bound to provide unbiased listings of airline services. Orbitz receives a per ticket fee for distributing airline services from charter associates which is fixed with significant annual price reductions over the term of the agreement. Orbitz receives either a fee or a commission from airlines that have decided not to become charter associates. Since the recent elimination of base travel agent commissions for tickets issued in North America, Orbitz charges the consumer a $10 fee to issue tickets on carriers that have not agreed to pay Orbitz a commission or a service fee. The consumer service fee charged to customers purchasing tickets on charter associate airlines is currently $5 per ticket. (Following the elimination of base commissions, most airlines reached agreements with many online agencies to compensate them for selling their tickets. In some cases, some airlines elected not to compensate some online agencies. In these cases, online agencies charge consumers higher service fees for tickets issued on those carriers. Orbitz did the same with respect to non-charter associate airlines that did not agree to provide some level of compensation to Orbitz.)

Orbitz's airline owners assert that two primary motives prompted them to create Orbitz. The first was to introduce more competition in the rapidly growing online market for leisure travel in an environment marked by two converging trends: 1) many leisure travelers demonstrated that they prefer a neutral, one-stop-shopping type of online travel agency with a broad range of travel element offerings rather than using individual carrier websites; and, 2) consolidation in the online travel agency environment was proceeding more rapidly than in the brick-and-mortar world, thereby reducing competition among distribution channels and increasing the power (and the willingness to exert that power) of the dominant players. Airlines were also enticed by the

[5] United, Delta, Northwest, and Continental initiated the Orbitz project and were later joined by American. All five airlines are considered by Orbitz as "Founding Airlines."

prospects of high returns on investments in the Internet world – and particularly in the fast-growing market for online travel agency services focused on leisure travelers.

The second primary motivation for creating Orbitz advanced by the airline owners was their desire to reduce distribution costs by exerting competitive pressure on GDSs. Airlines' distribution costs have been as high as 20% of expenses and constitute most airlines' third largest cost category. As other cost components declined, distribution costs continued to rise. Having cut travel agent commissions in an effort to trim these costs, airlines faced GDS fees that represent between 2% and 4% of the total ticket price. Due to the fact that most carriers need to be present in all distribution outlets, airlines became the primary source of revenue for the GDSs as they vied for market share by competing for travel agent subscribers, by offering them bonuses, free equipment, booking fee rebates, and other incentives. With few exceptions, most airlines have to be present in all systems in order to reach as many customers as possible. Because carriers cannot as a practical matter withdraw or threaten to withdraw from participating in any individual system, they have virtually no leverage on GDS pricing decisions. While GDSs compete for travel agency subscribers and other end users, they are not constrained in the booking fees they charge to airlines.

Internet Airline Distribution

Airlines have been steadily increasing the amount of internet bookings as a percentage of passenger revenues. PhoCusWright, an Internet research firm, reports that the Internet represented 14% of all airline sales for the top nine U.S. airlines in 2001, up from 8% in 2000. (These figures exclude sales made through corporate online systems such as GetThere and e-Travel.) PhoCusWright further notes that airline website sales totaled $6.9 billion in 2001, up 50% from 2000, while agency sales grew 40% to $4.9 billion.[6] Airline websites now represent 58% of airlines' total Internet sales while the remaining 42% of Internet sales are made through online travel agencies.[7] PhoCusWright reports that most airlines expect their own websites will grow at faster rates than online travel agency websites, but airlines will still use online agencies to sell some of their lowest fares, including merchant/negotiated fares, webfares, and opaque fares.[8] Airlines are adding additional features to attract customers to their websites, including: remote Internet check-in, frequent flyer promotions, and online frequent flyer awards redemption.

March 2002 Nielsen/NetRatings data show that nearly 43% of all web surfers accessed an online travel site during that month, compared to 39% in February 2002. Nine out of the top 10 online travel sites posted double-digit gains in March, lead by Expedia which increased 18% to 11.6 million surfers. Travelocity grew 24% in traffic to 10.2 million. Orbitz attracted nearly 6.6 million visitors, representing a 14% gain. Completing the list of the top five, Southwest Airlines drew nearly 5.2 million visitors, jumping 16% and CheapTickets.com surged 51% to nearly 4.4 million unique visitors.[9] Market share data for air bookings for the top three online agencies show that Travelocity has the largest share with 35%, Expedia has 34%, and Orbitz is number three with 31%.

In 2002, Forrester Research, another Internet research firm, predicts online spending will soar to over $20 billion. By 2003, more than 10% of the U.S. travel market will be booked online.[10]

[6] *Airline Web Sales Soar Despite Sour Year*, PhoCusWright, Inc., May 2002, p. 1.
[7] *Ibid*, p. 2.
[8] *Ibid*, p. 3.
[9] *Travel Commerce Report*, April 24, 2002 Vol. 1, Issue 14, p. 4.
[10] "Airline Websites: A Challenge from Online Agencies," *Financial Times*, March 13, 2002, p. XI.

Jupiter Media Metrix (another Internet research firm) is predicting that online travel sales in the U.S. will jump 29%, to $31 billion this year, and to $50 billion by 2005. They estimate that about half of that is from airlines' and other suppliers' own websites, leaving substantial room for the online agents.[11]

Despite such phenomenal growth predictions, it is important to keep in mind that traditional travel agents still reportedly sell nearly 70% of airline tickets. A Sabre official has similarly predicted that travel agencies will account for 65% of all airline bookings in 2005 (45% by traditional travel agencies and 20% by travel agency websites). When travel agencies make bookings, airlines pay booking fees to GDSs and, in many cases, incentive commissions.

Allegations Against Orbitz

The following list summarizes the concerns and/or objections to Orbitz expressed by Orbitz's opponents to the Department: 1) the MFN provision gives Orbitz "unfair" access to webfares in an environment where airlines are reluctant to make these fares readily available; even though the MFN clause is not exclusive, to prevent dilution of revenues, airlines generally do not distribute webfares in more than two places (e.g., their own websites and Orbitz); 2) based on the rate at which Orbitz has become a major competitor in the online distribution market, maintaining its access advantage to webfares will result in Orbitz monopolizing air travel sales by online agencies; 3) as Orbitz continues to gain market share by leveraging its inventory against its competition, the competitors will be forced to move away from selling air travel independent of package deals and towards other products to make up for lost revenue; in turn, there will be fewer intermediate distributors negotiating lower fares to sell to consumers; 4) once in control of the online distribution market, owner airlines will raise prices via Orbitz; 5) charter associates are using Orbitz for better visibility of some published fares, thus creating an environment that neutralizes fare wars; 6) members could use Orbitz to collude on pricing (as of yet, no claims have been made in this regard; however, it remains a concern); 7) the Orbitz business model harms the low-fare carriers and/or those carriers with low marketing budgets via in-kind marketing obligations; 8) although the Orbitz subscriber base is considerably lower in numbers than that of its competitors (at this time), Orbitz will continue to draw a higher look-to-book ratio[12] because of its access to webfares and, in turn, gain market share without strong competition; 9) Orbitz owners are protecting their investment by not making deals with other online agencies and using drawn-out negotiations whereby they reject offers equal to or better than "Orbitz economics" as smoke screens to cover their collusive behavior. Each of these concerns/objections will be addressed as they relate to the Conferees' four concerns.

I. Deviations from plans, policies, and procedures initially proposed in the joint venture's business plan and contained in its charter associate agreements

The Department has continued to monitor the implementation of Orbitz's plans, policies, and procedures. To date, implementation has been consistent with plans, with the exception of normal adjustments one would expect of a new business responding to rapid changes in a dynamic industry. For example, the terrorist attacks of September 11th occurred only three months after Orbitz's launch. Like many businesses, Orbitz responded by cutting costs to

[11] "Online Travel Takes Wing," *Business Week*, April 1, 2002.
[12] "Look-to-book" ratio is the number of air purchases by unique purchasers on any given website divided by the total unique visitors to that website.

conserve cash and was very conservative in ramping spending back to planned levels. Orbitz has represented to the Department that it has received no funds from its airline owners since September 11, 2001. Orbitz also instituted a service fee on all airline tickets sold, making what it regards as a deliberate decision to reach profitability even if at the expense of greater market share. Predictably, Orbitz saw a drop in bookings after implementing service fees.

Critics have alleged that the Orbitz business model is fundamentally uneconomic as a viable independent going concern. The Department has reviewed Orbitz's business plans in light of this allegation and finds evidence to the contrary, including Orbitz's filing with the Securities and Exchange Commission for an initial public stock offering. The Department cannot determine whether the owner airlines will in fact make an adequate return on their investment. It is true, however, that the Orbitz business model is *different* from those of its competitors and understanding the differences is important in determining whether the Orbitz model is restricting competition.

Orbitz maintains that its business model has two fundamental components: 1) to provide a new approach to the online agency business through a commitment to neutral displays and technological innovation to serve the online agency market segment; and, 2) to reduce the distribution costs of travel suppliers, largely by re-engineering GDS functions with new technologies to foster greater competition between GDSs and travel suppliers. Airline GDS booking fees have continued to climb without competitive discipline while general information technology costs have been steadily declining. Sabre, for example, increased its booking fees by 9% in 2001 and 3% in 2002.[13] The Internet age has not brought competition up the supply chain to affect the relationship between the airlines and the GDSs as expected. In fact, all major online travel agencies depend on GDSs for their booking capability. Online agencies joined their offline counterparts in their dependence on the GDSs. From the perspective of the travel supplier, they are also tied to a distribution fee structure that is not subject to competitive forces. Airlines saw a critical need to create incentives to reduce distribution costs -- namely by exerting more competitive pressures on GDSs by bringing to market innovative technologies enabling travel suppliers to bypass GDSs. This dynamic is central to understanding the impact of the Orbitz business model in the marketplace.

As with all new market innovations and changes -- and the airline distribution market has been marked by many radical changes since the advent of the Internet -- there are always dislocations and problems as all actors in the marketplace adjust to the realities of new dynamics and technologies. Prior to the Internet, airline ticket distribution costs were not substantially different among different sales outlets. Since the advent of the Internet, carriers report that the cost of distributing an airline ticket can range from as low as 25 cents to over $60, depending on the distribution channel through which the ticket is sold. If carrier A and carrier B are competing in a given market with a $150 roundtrip fare and have substantially different cost structures, the difference in net revenue obtained by carrier A, which can often distribute this fare at a cost of 25 cents compared to carrier B, which must often sell the same fare at a cost of $60, is competitively significant.

Orbitz maintains that it is committed as part of its core business plan to developing scaleable direct connect technologies for airlines that will significantly cut distribution costs, and claims it is making significant progress toward that goal. In the interim, Orbitz is using Worldspan as its booking engine (though not as its search engine) and is rebating a portion of the booking fees

[13] *Travel Distribution Report*, January 11, 2001 at 6. *Travel Distribution Report*, December 13, 2001, p. 1.

back to the airlines that have chosen to become charter associates. One Orbitz charter associate reports that the booking fee rebate via Orbitz lowers its distribution costs for fares booked on Orbitz by approximately one-third. Other charter associates report comparable savings.

"Direct connect" is defined as bypassing the GDS layer to communicate and book inventory directly with a supplier's host internal computer reservation system. "Scaleable integrated direct connect" is defined as "a network of Internet-based direct connections between suppliers' host CRS or PMS and participating travel agencies and corporate accounts and their accounting systems, allowing buyers access to multiple suppliers via one query."[14] Direct connection streamlines product distribution and reduces dependence on the services of GDSs. Carriers will save a substantial amount of money in booking fees, since they do not pay such fees on bookings in their internal system. Forrester Research, an independent e-commerce technology research firm, notes:

> A major airline like Delta Air Lines generated $15.7 billion in passenger revenues in 2000, but earned a net income of only $897 million. If 70% of Delta's revenues come via GDSs, GDS fees cost the airline $275 million. For Delta to cut those fees by one-third means that an extra $91 million drops to its bottom line, boosting its net income 10%.[15]

Forrester's study notes that the primary drivers of direct connect technologies are the GDSs' "archaic technology," the high cost of distributing via these systems, and the difficulty in differentiating and merchandising products in these systems. Building direct connect is complex and requires integrating various components of the ticket issuing process: passenger name record (PNR) synchronization and access, fulfillment, customer servicing, refund/reissue exchange functionality, reporting, and financial settlement. It is highly unlikely that direct connect will completely eliminate the need for GDSs due to the need to make non-direct bookings and for other purposes, such as interline bookings. Furthermore, direct connect requires a significant investment on the part of each airline and not all airlines may choose to make that investment despite the advantages of the technology. Direct connect is, however, likely to reduce the dependence of travel suppliers on the more limited and expensive GDS technology. Forrester predicts that, "The industry will move to integrated direct connect, a more productive and convenient network that links suppliers' hosts to one another and to travel agencies, corporate accounts, and travelers, using standard formats and the Internet backbone."[16] Orbitz is not alone in pursuing direct connect technologies. Other technology firms and at least one other online agency are pursuing direct connect technologies as well.

In its April 13, 2001, letter to Orbitz permitting its launch, the Department noted the inherent desirability of having new entry in the airline distribution business and having as much competition in the marketplace as possible to maximize consumer welfare. New entry is particularly attractive in light of the trend toward mergers and acquisitions among online travel agencies. We have previously noted that Orbitz's unique business model could potentially add a new element to competition among distribution outlets. We also noted the potential that Orbitz could spur competition by re-engineering older technologies to reduce airline costs.

The Department will be reviewing the implementation of the Orbitz business model and its components, including criteria for direct connect priorities, to ensure that they are fair and non-

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[14] Harteveldt, Henry H. The Forrester Report, *Travel: Direct Connect Isn't Enough*, October 2001, p. 10.
[15] *Ibid*, p. 14.
[16] *Ibid*, p. 8.

discriminatory. The Department will monitor future developments to see whether Orbitz obtains market power in the online distribution business and, if so, uses any such power in ways that could prejudice airline competition.

II. The extent to which the joint venture has adhered to its commitment to not bias displays of fares or services

The Department has discussed this issue with all parties concerned. Based upon all available evidence, Orbitz has adhered to its commitment not to bias displays of fares or services. The charter associates themselves have been particularly vigilant in making sure that Orbitz complies with its contractual commitment to offer neutral displays. The "Orbot" search engine even produces an unbiased display when the consumer starts from a sale landing page, which is reached when the consumer is searching more information about a single carrier's advertised fare sale. Some parties have raised questions about aspects of the neutral display criteria used by Orbitz, and these questions have been addressed by Orbitz. As with all websites, such issues often involve architectural bias inherent in interfacing various types of technologies. Indeed, there are often differences in the fares being offered on airline websites, online agencies, and Orbitz at any given time (even when they are all authorized to sell the same fare) depending on the technology and procedures used by the GDSs that serve as website booking engines. Some GDSs have the capability to process various types of fare discounts faster than others and some GDSs process fare loads more quickly than others. These differences mean that, even if fares are available on different websites, they may not appear at any given time due to such technological differences.

Orbitz's unique contractual commitment to unbiased displays limits Orbitz's ability to use the same tools as other online travel agencies. For example, Orbitz is prevented from negotiating commissions, override commissions, and from selling forms of screen presence (advertisements in the booking paths, preferred carrier booking paths, etc.). Other online agencies view these tools as central to their businesses. In many cases, online agencies hold themselves out to airlines and other travel suppliers not as travel agencies, but as "travel marketing companies that support the direct sales of their travel partners." They often promise to provide more than the airline's fair share of tickets (based upon the airline's current market share) in order to obtain greater compensation from airlines. Such arrangements are designed to move market share from one carrier to another. Online agencies claim that they do not bias their displays and that they only use techniques like banner ads and preferred airline selections to increase an airline's market share.

Online agencies routinely develop preferred provider programs to enhance the compensation they receive from airlines and other travel suppliers. Since they do not charge fees to consumers for their services, they are reliant upon travel suppliers for much of their revenues. Online agencies argue that their model gives them the incentive to get better deals for consumers from airlines and others. They also legitimately argue that advertising is pro-competitive and gives new entrants a chance to gain market share. Vanguard Airlines states in a recent letter that it is, "increasingly concerned that, with the increasing domination of Orbitz, consumers are lured away from independent agencies, where smaller airlines have greater opportunities to establish name recognition and gain passengers from the larger airlines."[17] Given the nature of some of the

[17] Letter of Robert M. Rowen dated April 30, 2002, addressed to Representative Mike Pence and copied to the Associate Deputy Secretary of Transportation, Docket OST-97-2881, p. 2.

arrangements, it is not self-evident that there is *always* a positive net benefit for the consumer when compared to a model that is free of what some e-commerce analysts refer to as "presence bias." Some consumer groups have cited the display of ads in the booking path and the prominent feature of buttons triggering exclusive displays of preferred carrier flights as examples of prejudicial behavior that can be harmful to consumers. There are therefore many complex inter-related factors that must be considered in making a determination about net consumer benefits, one of which is the economic relationship between suppliers and distributors. The introduction of the Orbitz business model in the marketplace shows that a heterogeneous mix of distributor business strategies can promote more competition. Orbitz's opponents argue that, if Orbitz obtains a dominant position in the online travel agency business, it could drive competing agencies out of the market and undermine airline competition.

Some Orbitz charter associates (owner and non-owner) have expressed a preference to use an online agency with a contractual commitment to unbiased displays as it takes commission override arrangements out of the equation. Small carriers have traditionally felt disadvantaged by the travel agent distribution model predicated on such inducements. Through unbiased display, airline fares alone stimulate competition.

Some smaller low-fare carriers who favor the Orbitz commitment to unbiased displays have, however, chosen not to become charter associates. The primary reason cited by most low-fare carriers that do not participate in Orbitz is that the MFN provision restricts the "exclusivity" of their own websites and reduces their ability to attract consumers to this lowest-cost distribution channel. They also do not want to lose their ability to selectively engage in deals with other online agencies and distribution channels without the obligation to also give these deals to Orbitz. In addition, one carrier cited other specifications in the Orbitz agreement that it felt were designed to burden small low-fare carriers with higher distribution costs (namely, the in-kind advertising commitment.) As part of the in-kind advertising formula is based on revenues generated from the site, one low-fare airline argues that the airlines with the lowest fares will gain market share via Orbitz and in turn, be obligated to pay additional in-kind marketing costs for it. Even if in-kind marketing is considered soft-dollar, lower budget airlines view this kind of marketing as lost opportunity to gain hard dollar advertising from other commercial partners to further reduce their costs. Further, one carrier reports concern about the cap in the annual marketing support obligations. If the large carriers' market share calculations exceed the cap and small carriers do not, the marketing support burden would fall more heavily on the smaller carrier. The Department has examined this situation.

Orbitz maintains that its business model is predicated on a contractual obligation to unbiased presentation of airline services, which prevents it from accepting traffic-share shifting overrides and preferred carrier relationships and could ensure that competition in the online agency business remains robust and focused on the consumer. The Department's review of documents outlining negotiations between selected carriers and online agencies suggests that, since Orbitz has begun operations, some carriers have placed more emphasis on the neutrality of displays both in the published fare environment and the opaque fare environment. In one case, an Orbitz charter associate reports that an online agency wanted the right to refuse acceptance of a fare if that fare conflicted with a preferred carrier relationship it had with another airline. In its negotiations with another online agency, one Orbitz charter associate sought to obtain a written commitment to unbiased airline agency displays. The agency resisted, insisting on the ability to give preferential display positions to its airline partners.

One Orbitz charter associate claims that its share of sales in Orbitz is comparable to its sales through other online agencies, but is slightly larger in Orbitz because of Orbitz's neutral display. Orbitz's competitors, however, maintain that such differences in sales are due to Orbitz's greater access to webfare inventory. Another Orbitz charter associate also contends that it does not receive its fair share on some online agencies, especially in particular markets, and suspects this is due to preferred carrier relationships. Another Orbitz charter associate notes that by providing an unbiased option for air travel suppliers, Orbitz reduces the leverage of other major online agencies to extort benefits from biasing. Another Orbitz charter associate believes that it is not getting its fair share of sales in other online agencies and has been prohibited from matching Internet-only fares provided by one agency's preferred providers. This charter associate claims that the agency refused to accept its webfares when filed as webfares. As a result, this carrier matched the fares in the published fare environment but, according to the carrier, its fares still did not show up in the agency's promotional displays for the Internet fare offerings of its preferred providers.

Orbitz charter associates continue to negotiate with other online agencies to provide inducements for moving market share on the agencies' websites, much as they have done with traditional travel agents for years. Many airlines are keen to provide overrides when online and offline travel agents book more than the airline's fair share based upon its existing market share in a given market. Several Orbitz owner charter associates have concluded new agreements with other online agencies that will drive share to these carriers – something the carriers acknowledge Orbitz by design cannot do. The Department observes that the terms of override agreements in the online and offline travel agent environments appear to be increasingly detailed and aggressive in their share hurdles and targets. Online agencies report that Orbitz owner charter associates are demanding more stringent market override targets in exchange for obtaining even limited access to webfares at the carrier's sole discretion.

Orbitz cannot negotiate fees charged to charter associate airlines for issuing tickets. The fee schedule is fixed in the charter associate agreement and is the same for all carriers. This design could ensure that large and small charter associate carriers are treated equally. Orbitz cannot, however, negotiate lower fees with non-charter associate carriers unless it is also prepared to give charter associates the lower fees. While such a regime could ensure that small carriers will be treated equally with large carriers despite differences in volume (which would normally translate into better economics for larger carriers), in the long-run it may mean Orbitz's fee structure constitutes a distribution price floor, which could be problematic. In dealings with other online agencies, airlines are also keen to ensure that they receive market-leading distribution fee rates comparable to the best deals of their competitors and have negotiated similar MFN-type fee clauses into their contracts with different online agencies.

III. The extent to which ties between the airline-owners and the "Most Favored Nation" clause in the charter agreement have resulted in monopolistic or other anti-competitive market behavior

Among the Department's major concerns with Orbitz has been whether the Orbitz charter associate agreement unduly restricts the airline charter associates' incentive to compete in the distribution of their services due to the MFN clause. The MFN clause in the Orbitz charter associate agreement requires the signatory airline to give Orbitz all of the published fares it offers to any other third-party Internet agency, provided that Orbitz is able to match the terms offered by that Internet agency. Another provision in the same clause of the charter associate agreement requires that the signatory airline provide to Orbitz all of the published webfares it offers on its own airline website. In its six-month report, Orbitz states that the third-party MFN provision has not been officially invoked. This is largely due to the fact that an airline routinely puts on its own website any fares an airline agrees to provide to third-party Internet sites and, as such, it is covered by the other MFN-like provision of the Orbitz charter associate agreement. Orbitz contends that both provisions are expressly non-exclusive and that the agreement does not prevent the carrier from also selling all of the fares it gives to Orbitz anywhere else on the Internet. Furthermore, if a competitor offers to undercut Orbitz, Orbitz must match the terms of the offer to sell those fares. If Orbitz does not or cannot match the terms, the MFN obligation does not apply. The MFN provision applies only to published fares.

Orbitz's competitors charge that, whether or not it is being invoked directly, the MFN clause has had a significant effect on how Orbitz charter associates offer and sell their inventory. If an airline is sensitive to the broad dissemination of discounted published fares (presumably due to concern about an aggressive competitive response) and it is required to sell such discounted fares on Orbitz as well as its own website in all cases, then the carrier will be reluctant to further increase the dissemination of these fares on other websites. Critics further argue that the MFN clause undermines the incentive of individual airlines to make clandestine deals with other Internet travel sites – deals that they contend have a pro-competitive effect on airline pricing.

In its April 13, 2001 letter to Orbitz, the Department noted potential mitigating factors on the impact of the MFN clause:

> First, other agencies are free to match the terms of the Orbitz contract. In addition, the MFN agreement itself appears to provide some flexibility for charter associates which may ameliorate potentially anticompetitive effects on the market dynamic. For example, the MFN "does not obligate Airline to delay or forego a commercial opportunity due to Company's [Orbitz's] inability to proceed with a similar commercial transaction with Airline for technical, financial, or other reasons." Furthermore, Orbitz is contractually bound to being unbiased. It is committed on the record to not providing advertising for any "preferred carrier" which pays for such displays along the air booking path. If a competing online agency offers to sell air carrier advertising in the air booking path or offers some other form of "presence bias," the MFN clause is inapplicable according to Orbitz's documentation. Further, if a competitor offers the airline faster or better technology or price terms that Orbitz cannot match, the airline has no obligation to "delay or forego" the deal. Essentially, it is our understanding that if Orbitz cannot match the deal, it does not get it. Many of the "special deals" commonly negotiated between airlines and online travel agencies may therefore not be covered by the MFN clause. In sum, this provision of the MFN, the limitations on the types of fares covered by the MFN, and the fact that many carriers have not become charter associates may mitigate the negative impact on the negotiation dynamics in the market and the effect it may have on price or innovation.

Some competing online agencies argue that Orbitz's economics have set the market price for distribution costs, but that they do not know precisely what these terms are and therefore have difficulty precisely matching them without losing leverage in the negotiation process. These terms are contained in the charter associate agreement and are the same for both owner and non-owner charter associates. Nevertheless, some online agencies have approached airlines directly and have asked for a list of the specific economic terms of the agreement. Carriers responded by citing antitrust concerns and the non-disclosure provisions of the agreement that prohibits them from releasing the terms of the agreement. The Department's review of the documents indicates that Orbitz's competitors do, in fact, have a good understanding of Orbitz's economic terms and have endeavored to match them, usually within the confines of their business models.

The question now before us is what has been the actual effect of the MFN provision to date in the marketplace and its future implications. It is important to note at the outset that the online travel distribution marketplace is changing very rapidly. The terrorist attacks have had the added effect of interrupting ongoing trends in the marketplace as all travel related businesses have struggled to regain their footing. As a result, if this review were written only one month earlier, several critically salient developments would not have been known. It cannot be overemphasized that the online travel distribution market is still very fluid and no one can predict how it will evolve. New products and innovations of all sorts are being developed that have great potential. Mergers and consolidations currently in progress involving various forms of vertical and horizontal integration are fundamentally changing the competitive dynamics in the industry. What follows is, therefore, very much a "snapshot" picture of a rapidly moving target.

Unsurprisingly, as a new entrant with a unique business model, Orbitz has had an impact in the marketplace. As *Time.com* succinctly stated, "Travelocity and Expedia were until recently the duopoly that ruled the online travel business. Orbitz is making it a three-way fight."[18] Prior to Orbitz, most, perhaps all, Orbitz charter associates only offered their webfares on their own websites. Due to the lower costs of distribution on Orbitz (and its contractual commitment to driving them even lower through technological innovation), these carriers' webfares are available on Orbitz as well as their own websites, giving more consumers greater access to webfares and facilitating easy comparison shopping for webfares.

One charter associate maintains that the MFN provision has had a significant effect on how it offers and sells its inventory and believes that the consumer is disadvantaged by the limitations imposed by the MFN clause because it restricts the carrier's ability to negotiate promotional arrangements with various online distribution outlets. This carrier has exploited opportunities to obviate the MFN provision by offering fares to online agencies' membership bases for which access is limited by password or other protective measures. This carrier believes that, if the MFN clause were removed from the charter associate contract, it would be able to extend exclusive promotional offers to each of the online distribution outlets and that consumers would then have a larger number of low-fare options for the purchase of the airline's services. Further, while it does not seek to hide low fares from consumers, it would also like to be able to limit distribution of its lowest fares to the outlets that afford the most cost-effective distribution to the target audience. Finally, it outlines the conundrum many airlines face: the more outlets through which the company distributes its fares, and the more visible these outlets become, the more likely it is that competitors will match their fares, thereby reducing the uniqueness of the initiating airline's fares.

In recent months, the press has reported that Orbitz charter associates Alaska, American, Continental, Delta, Northwest, and US Airways have reached agreements with major online websites that involve some level of access to webfares. More specifically, Travelocity has announced marketing agreements with Continental, Delta, and Northwest, and Expedia has publicized agreements with Continental, Delta, Alaska, and US Airways. The Department has confirmed these reports and has obtained confidential information about the terms of these agreements. The willingness of some airlines to engage in deals with other online agencies that potentially grant those agencies access to some webfares has produced examples of an interesting

[18] "The 50 Best WebSites" Time.com, April 1, 2002. Vol. 159. No. 13.

competitive dynamic. In one instance, for example, one Orbitz owner charter associate initiated a sale on Orbitz and its own website. An Orbitz non-owner charter associate matched this sale on its own site, Orbitz, and a third online agency site. Another Orbitz owner matched the second competitor's response, broadening the markets included in the sale and extending the availability to other Internet sites. Finally, a third Orbitz owner matched the fare sale on all Internet and traditional brick-and-mortar agencies (by making them open for sale to all GDS users).

In addition to providing some limited level of access to published webfares, Orbitz charter associates have been concluding deals with major online websites for opaque and net fares – fare products that are traditionally much more lucrative for travel agencies than are published fares. Orbitz charter associates have also engaged in some ad hoc deals and promotions with major online travel agencies that Orbitz cannot match. These typically fall into two broad categories: 1) deals involving exclusive fares that also include a targeted increase in market share; and, 2) deals that involve an e-mail marketing campaign to target a number of registered users that exceeds the number of registered users on Orbitz.

While some deals between Orbitz charter associate airlines and other online agencies provide limited access to published webfares at the carriers' discretion, carriers have refused to give Orbitz-like MFN status to other online agencies. There may be a number of reasons for this, such as the following: 1) carriers seek to avoid eroding Orbitz's comparative advantage in the marketplace; 2) owner airlines seek to secure their investment returns in light of an eventual Orbitz initial public stock offering (IPO); 3) other online agencies have not met, in whole or in part, certain aspects of Orbitz's economics and/or business proposition; and 4) airlines are unwilling to commit to greater proliferation of webfares and thereby erode their control over pricing and potential revenue dilution that might result from doing so.

Since the launch of Orbitz, major online agencies have been aggressively pursuing agreements with owner charter associates that would give them the same access to webfares as Orbitz. Major online agencies report they have made offers to the owner charter associates that are equal to or better than the arrangements they have with Orbitz. Nonetheless, until very recently, they contend that no Orbitz owner had made a genuine effort to enter into those agreements and/or had made demands during negotiations that were unrealistic or would jeopardize the financial well-being of the agency (e.g., total GDS rebates alongside zero commissions, technological improvements within short periods of time, an equity stake in the agency). Orbitz's competitors, therefore, reason that these actions, or lack of actions, expose Orbitz's anti-competitive behavior and intent to monopolize the sale of webfares. In recent months (February and March 2002), charter associates, including owners, have made deals with Travelocity and Expedia for the sale of webfares at the sole discretion of the carriers. The agencies complain, however, that, despite their matching (or bettering) Orbitz's terms, their access to webfares has been both limited and sporadic and does not compare to the volume and frequency of webfare availability on Orbitz. They observe that Orbitz's displays often begin with several pages of webfares that are not available to them. The agencies allege that the owner charter associates are only entering into these agreements to appear fair and unbiased in their distribution practices during a time when the regulatory agencies (DOT and DOJ) are investigating them.

The Department is examining the extent to which the online agencies have indeed matched Orbitz's economics. This examination is very difficult for several reasons. First, built into the Orbitz charter associate contract is a fixed, declining ticketing fee schedule over several years. Second, part of the Orbitz business proposition is its firm commitment to develop and implement direct connection technologies, giving carriers additional value that is very difficult to quantify, particularly when compared with the shorter-term contracts typically concluded between other online agencies and airlines. Third, since other online agencies are structured around the traditional travel agency business model that is based upon supplier inducements and minimal (in most cases no) fees to consumers, agreements between Orbitz charter associates and online agencies typically involve overrides which Orbitz cannot negotiate and the value and cost of which are dependent on changing market conditions. Since most of these agreements are quite new, there is not much data history to evaluate the cost/benefits of these agreements to either the airlines or the agencies and to compare them with the Orbitz arrangement. The comparison is further complicated by the fact that Orbitz is committed to neutral displays, to avoid placing airline advertisements in the air booking path, and other similar measures that are difficult to value and quantify vis-à-vis override commissions and screen presence enhancements that other online agencies typically offer, and had been offering prior to Orbitz's launch.

Orbitz considers the MFN provision a central piece of its business proposition. The fact that it has not been formally invoked does not mean that it is unnecessary from Orbitz's perspective. Indeed, it could simply mean that carriers are abiding by the terms of contracts they have voluntarily signed. Orbitz has previously represented that the MFN clause was, in fact, designed "to facilitate entry by a small player without market share in the face of existing, entrenched competitors and thereby lower distribution costs." Orbitz's access to webfares, neutral display, and technology have contributed to its successful entry in the marketplace. A significant portion of Orbitz's bookings are indeed webfares. A recent study by Thomas Weisel Partners, searched 13 online travel sites (including agents and suppliers) for prices on roundtrip flights in the top-20 markets on two specific dates. The study concluded that:

> (1) Orbitz is able to locate the lowest ticket price more often than either Expedia or Travelocity.com, (2) Orbitz's prices are more than $20 better on average, and (3) the airlines themselves frequently have the best price. The simple story is that airline tickets are a commodity item and Orbitz, more often than not, has the best price. That price advantage should continue to produce market share gains for Orbitz and pressure the other leading agents to move more rapidly toward other travel categories, in which pricing is less competitive and Orbitz does not have an edge. As we have argued in the past, Expedia's focus on the discounted hotel room category positions it well competitively. Travelocity.com has made progress but remains heavily weighted toward ticket sales and has consistently lost market share.[19]

Online agents are following their brick-and-mortar counterparts in concentrating on products such as hotels, rental cars, and cruises which have higher commissions. Travel agents note, however, that air is an important and necessary element in many travel plans and that access to a full range of published airfares is critical to serve customers effectively. While the majority of brick-and-mortar travel agents charge customers service fees for air-only transactions, many online agents have been reluctant to do so because they believe the absence of a service fee induces customers who would normally use a brick-and-mortar travel agent to book online to save the service fee. Online agents further argue that consumers would be harmed if they were forced to reduce their focus on air service and concentrate on other travel elements. They contend that Orbitz is no longer a new entrant and that therefore the MFN provision is no longer necessary and prevents them from bargaining with airlines to get low fares for their clients.

[19] Fuller, Jake. *Survey Says: Orbitz has the Best Prices*. Thomas Weisel Partners, February 6, 2002, p.2

Orbitz argues that it is still a new entrant and, as such, has a disadvantage in the marketplace. Orbitz notes that its principal competitors, for example, have preferential or exclusive arrangements with the major Internet portals (such as Yahoo!, AOL, MSN, and others) which are important in promoting a new brand in the online environment. Only one of these major portal contracts will expire within the next several years, giving Orbitz and other competitors a chance to place a competitive bid. Online agencies who have these portal arrangements, however, regard them as important, but not central to their businesses. They report that traffic coming to their sites from portals with whom they have agreements is less productive than other traffic (i.e., such traffic has lower conversion ratios) but nevertheless traffic coming through the portals accounts for a significant share of their ticket sales. Regardless of the productivity of the traffic gained through portal deals, such arrangements can substantially contribute to a webite's visibility, name recognition, and database of users, all of which are extremely valuable to a new entrant.

Orbitz contends that its marketing strategy is based on "having the most low fares," in part, to differentiate itself from its competitors and gain a larger customer base to match those of its competitors. However, Southwest and a number of other low-fare carriers continue to refuse to participate in Orbitz as charter associates, discrediting any claim Orbitz could make regarding always offering "the lowest fare" or being a "one-stop" shopping center for every airline's lowest fare. Studies continue to show that most consumers consult on average three websites before purchasing. The best price and the best combination of schedule and price appear to be the dominant drivers of purchasing decisions. While Orbitz may be the third largest online agency, it is far behind in its subscriber base compared to Travelocity and Expedia.

Orbitz has entered a business marked by incumbents enjoying various forms of vertical and horizontal integration. Since Orbitz's launch, the two major incumbents, Expedia and Travelocity, have both become profitable in a market in which all companies are growing because the entire market is growing. Nevertheless, there is a trend toward greater horizontal and vertical integration of both of the major incumbents as well as others. Sabre, the largest GDS operating in the United States, has reacquired complete ownership of Travelocity. Similarly, Cendant has acquired another GDS, Galileo, as well as Trip.com and Cheaptickets.com and plans to relaunch these websites. Given that Travelocity and Trip.com/Cheaptickets.com are becoming the Internet front to their GDS system parents, the GDSs could obtain additional market power and the opposition to alternative technologies that could perform GDS functions at a lower cost could become particularly intense in the online travel agency marketplace. The second component of Orbitz's business strategy – re-engineering some GDS functionality using new, cheaper technologies -- represents a clear threat to the GDSs. Forrester Research, an Internet technology research firm, points out:

> Booking fees' days are numbered. In 2000, 82% of GDS revenues came from booking fees – 87% of which came from airline reservations, which average $4 per segment. By 2006, the GDS firms expect that booking fees will fall to 56% of their revenues, a 32% decline, and that there will be a revenue loss of $1.5 billion just for the three publicly held GDSs, based on 2000 earnings. … With airlines financially strapped, cash-rich GDSs will take advantage of depressed prices to snag new travel technology firms with the capacity to disintermediate them – as Sabre did with GetThere and Amadeus did with e-Travel, Inc. – to benefit financially from the new IDC [integrated direct connect] environment.[20]

[20] Harteveldt, Henry H. The Forrester Report, *Travel: Direct Connect Isn't Enough*, October 2001, pp. 14 and 16.

Meanwhile, Microsoft has sold its controlling interest in Expedia to USA Networks, which plans to integrate Expedia into its multi-media operations. In light of such market developments, Orbitz currently faces two very large competitors with access to substantial resources. Airlines' continued commitment to, and support of, Orbitz is likely to be contingent on Orbitz's ability to reduce distribution costs, which could provide greater competition in the online agency and GDS markets. Orbitz views the MFN provision as a key part of its strategic position in the online travel agency marketplace that is also important to supporting Orbitz's role as technology developer and provider.

If the charter associate arrangements and some of Orbitz's technology are non-exclusive by design as Orbitz claims, they are unlikely to provide sustainable advantages. Recent cuts in travel agent commissions may begin to erode Orbitz's cost advantages, and webfares are appearing on competing websites. Existing major online agencies, unlike Orbitz, have several years of experience in developing a complete range of travel information and services. Their customer databases, substantially larger than Orbitz's, might be leveraged to get even Orbitz owner charter associate airlines to engage in promotions. The cost of customer acquisition for a new entrant to acquire the baseline of customers that is the lifeblood of a travel agency is particularly high for a new entrant in a tough, thin-margin business. Orbitz's competitors may be able to compensate for periods of lower bookings by leveraging the advertising support in their airline marketing agreements to generate incremental transactions using e-mail campaigns. The bigger the database of customers, the greater the market leverage of the online agency. For example, all online agencies (including Orbitz) routinely contact carriers to encourage them to offer promotions on their websites. Agencies with large customer databases are able to offer greater marketing reach to airlines. Any comparative advantage afforded by the MFN clause might be limited over time if airline charter associates offer webfares to other online agencies, as they are permitted to do under their agreements with Orbitz. If other agencies are successful in gaining access to a sizeable volume of webfares based on recently concluded agreements, Orbitz's marketing advantage may be gradually eroded.

Despite the fact that the Orbitz MFN provision gives Orbitz the right to have fares that are put on a third-party Internet site, it does not appear, based on evidence reviewed to date, that Orbitz has access to, or knowledge of, every single deal taking place between airlines and online agencies. Charter associates have a vested commercial interest in keeping competitive information confidential – at least until a special offer is open for sale. However, except for opaque/net fares which airlines do not typically offer on their own websites (and which Orbitz does not offer), airlines rarely if ever put published fare discounts on third-party websites that they do not also offer on their own websites. Hence, any fare offered by an Orbitz charter associate to a third-party Internet agency and placed on the charter associate's own website is automatically covered.

One online agency reported an instance in which an airline gave Orbitz information on an offer made to a competing online agency and one of Orbitz's owners reacted in a way that suggested it had gotten information on the offer. Orbitz itself voluntarily informed the Department of this same incident as the one and only occasion of a charter associate contacting Orbitz to notify it that it had reached an agreement with a competitor for a special promotion that Orbitz would have to match to also receive. It was unclear whether Orbitz would be able to match the deal when it was discovered that the airline intended to distribute the promotional fares on its own website as well and was therefore covered by the charter associate agreement. Like the staff of most online travel agents, Orbitz staff routinely contacts airlines to encourage them to offer new promotional fares. Orbitz has, however, represented that under no circumstances are these issues discussed with, or presented to the Board of Directors of Orbitz Inc., or the Board of Managers of Orbitz, LLC.

The Department has also monitored Orbitz to determine whether Orbitz is a vehicle for price and/or service collusion or coordination and thereby reduces competition. We have evaluated the technological architecture employed by Orbitz and procedures for its use through site visits to Orbitz headquarters and inquiries with carriers that both participate in Orbitz as charter associates and several that do not. Orbitz continues to use the standard industry fare filings with the Airline Tariff Publishing Company (ATPCO) for all fares it sells. While webfares sold on Orbitz are filed, without exception, through ATPCO, webfares have not, in contrast to other published fares, historically been open to the view of competing airlines through ATPCO. Because webfares could be found on an airline or other online site, Orbitz does not make new information public. Critics of Orbitz contend, however, that Orbitz facilitates collusion by creating a single site for monitoring competitors' webfares.

While Orbitz and some consumer groups contend that Orbitz's display of all webfares of its charter associates in one place facilitates consumer comparison shopping and enhances competition, some online agencies contend that it reduces the charter associates' propensity to conclude clandestine deals with other online travel agents, in part because the risk that competing airlines will match and escalate into ruinous price wars is higher due to the greater visibility of webfare offerings. In addition, smaller airlines in particular have the desire to offer such fares "under the radar" of their larger and more powerful competitors, shielding them from an aggressive competitive response. The ability to offer them only on their own websites provides such "cover," provided that competing carriers do not monitor the website offerings of their competitors. Others contend that Orbitz makes it easier for airlines to monitor the actions of their competitors and thereby has a chilling effect on competition.

The increasing number of opaque fare offerings and the increasing number of online agencies that offer this product provide new outlets to a carrier that seeks to shield itself from a more substantial competitor's response to its fare initiatives. Orbitz itself does not currently offer opaque fares. Other online agencies have developed a "merchant model" whereby they negotiate for net fares from the airlines and then resell them to consumers at a mark-up, or package such net airfares with hotel, car, or other travel elements under one price quotation. While the merchant model does provide airlines opportunities to market opaque fares "under the radar," opaque fares are less attractive to consumers and are largely considered by airlines to be a separate product market from published webfares.

The Department has also examined whether the provision in the in-kind promotional marketing agreements allowing an airline to get a limited amount of credit each year (toward its in-kind promotional support obligation) by offering special fares exclusively to Orbitz has been invoked and what effect it has had. The evidence reviewed to date shows that no Orbitz charter associate airline has provided exclusive fares to Orbitz. All fares provided to Orbitz have, at a minimum, also been available on the charter associate's own website. As a result, this optional provision of the in-kind marketing agreements has not been exercised.

IV. Whether airline-owners of the joint ventures or charter associates have acted in an anti-competitive manner by choosing not to distribute fares through other online distribution outlets

The Airline Perspective

The Department is examining whether the MFN clause as a practical matter keeps airlines from negotiating any special deals with other online travel agencies. Among the reasons cited by the Department in its April 13, 2001, letter permitting Orbitz's launch, we gave three primary reasons why the argument that Orbitz would reduce competition among online agencies by quickly attaining a dominant position in the online agency business and causing irreparable harm was unpersuasive:

> 1) the incumbent online travel agencies enjoy a significant "first mover advantage" and have far more experience in dealing with the online environment, and they continue to bring innovations to the market to compete and differentiate themselves; 2) many carriers (including a number of low-fare carriers) have decided not to become Orbitz charter associates, which means that Orbitz cannot claim to be a one-stop shop for the lowest fares; and, 3) even Orbitz owner and charter associate carriers have a strong economic interest in minimizing distribution costs by serving customers through their own websites (thereby exerting a natural counterbalance) and are therefore less likely to market through Orbitz in a monolithic way.

Airlines continue to drive as much of their total sales as possible through the Internet to reduce costs. Their ability to channel traffic appears to be limited, and most carriers have generally sought to be present in as many Internet distribution channels as possible. This is evidenced by the swiftness with which carriers who cut travel agent commissions to zero reached agreements with the major online agencies to continue selling their tickets through these outlets by adequately compensating them for doing so.

While most carriers seek to sell seats through as many distribution outlets as possible, some carriers prefer to limit the number of distribution channels through which they sell all of their fare products. Southwest and JetBlue, for example, have achieved considerable cost savings by limiting the number of their authorized distribution channels. Interestingly, Southwest tickets are not available for sale in any online travel agency website since Southwest pulled out of Travelocity, which uses Sabre – the only GDS through which Southwest tickets can be booked.

Carriers typically consider a number of factors in developing a comprehensive distribution strategy including the following: whether the distribution outlet's flight/fare display is opaque or non-opaque; the size of the distribution outlet; how the distribution outlet compares with its competitors; the nature of the fares and services offered by other airlines through the distribution outlet; the user profile of the distribution outlet; the distribution practices of competing carriers; the manner of distribution used for competing fare products by other airlines; the impact of more selective distribution practices on the airline's relationships with customers and distributors; and, the impact of distribution practices on the carrier's revenue management objectives.

Even before the advent of the Internet, airlines did not treat all distribution outlets the same with respect to the fares that they are authorized to sell. Travel suppliers have long used consolidators to sell seats at low fares not available to travel agencies and airline reservations agents. Airlines commonly give favored travel agencies specific access to discount fares and marketing benefits and enable favored agencies to waive some restrictions on discount fares and to book customers on oversold flights. Requiring carriers to distribute all fares through all channels might, in fact, decrease competition in the distribution supply chain. The Department has interpreted the aviation statutes as allowing airlines the same degree of flexibility in deciding how and through what retail channels to sell their services as producers in other industries have, consistent with antitrust principles.

While airlines use webfares to generate incremental revenue, this no longer appears to be their primary purpose. Most airlines view the primary purpose of webfares as a tool to induce consumers to use low-cost channels of distribution and to reduce airline distribution costs. This is a central goal of many airlines' online distribution strategies.

All airlines, but low-cost carriers in particular, want to sell their lowest fares only through their lowest-cost distribution channel, which is invariably their own website. This is a reason cited by many carriers, including Southwest, in explaining why they do not want to participate in Orbitz. For them, the trade-off for putting their webfares on Orbitz as well as their own site increases their distribution costs (even though Orbitz costs are lower than many other alternatives, they are still higher than the airline's own website). Some low-fare carriers give some of their webfares to other online agencies and allow those agencies to add a mark-up and resell them to consumers. Others seek to retain control over the pricing of their product and choose to keep these fares only on their own websites.

Many carriers (including both Orbitz charter associate owners and non-owners) have averred a willingness to expand the availability of webfares to all channels prepared to offer them long-term, low-cost distribution economics and are using webfares as an inducement to obtaining such commitments from a variety of distribution channels. Some industry observers currently estimate GDS booking fees (even for online bookings using a GDS) at $4.30 per segment. Forrester Research notes that, "airlines not only depend on GDSs the most, but they also pay the highest fees – between $12 and $17 for an average ticket, versus $4 to $8 for a hotel booking."[21] Northwest Airlines has estimated that its booking fee costs in 2000 equaled 2.1% of its system passenger revenues.[22] Forrester predicts that integrated direct connect will help airlines cut more than $1.4 billion in distribution costs.[23]

The new ability for consumers to compare and shop different GDSs (which power all of the major online travel booking websites) makes the performance of the GDS even more critical to an airline's success than in the past. This is perhaps particularly true for low-cost carriers which seek to retain their low-cost advantage in the face of rising GDS fees, yet retain the presence of their product on as many virtual shelves as possible. The Department's review of several online agencies reveals substantial differences in the cost of distributing an airline ticket through those channels, even after removing differences between various commissions and override commissions and other variable items in agreements between individual airlines and online agencies.

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[21] The Forrester Report, *Travel: Direct Connect Isn't Enough*, p. 5.
[22] *Travel Distribution Report* (June 14, 2001), p. 4.
[23] The Forrester Report, *Travel: Direct Connect Isn't Enough*, p. 2.

Many carriers consider lower booking fees and commitments to bypass the GDSs entirely as important components of their negotiations with online agencies. If their overall strategy is successful, the traditional GDS-dependent distribution channels may become lower cost and make them more competitive. Given this strategic goal, many carriers view lower costs solely on sales of webfares through a normally high-cost distribution outlet to be an inadequate business proposition since it would impair the overall objective of lowering all distribution costs. Presumably, direct connect solutions provided by Orbitz and others will provide online and offline travel agents with additional tools to serve their clients at lower cost to travel suppliers. Direct connect technologies could also prod GDSs to reformulate their supplier-funded, travel-agent-inducement-driven pricing paradigm that shields booking fees from competitive discipline. Forrester Research contends that:

> Direct connect lets more Web agencies sell Web-only fares. The airlines don't sell their Web-only fares beyond their own sites and Orbitz because of GDS booking fees and agencies wanting commissions on these sales. Because direct connect helps eliminate the GDS fees, revenue-hungry airlines will allow more Web agencies, like Trip.com to sell these fares.[24]

Many Orbitz charter associates argue that the MFN provision has not had a significant impact on how they offer and sell their inventory. The Department's initial review has shown that Orbitz still has the lowest distribution costs of the online agencies, though some agencies have worked hard to achieve parity in contracts with Orbitz charter associate airlines, within the confines of their business models. However, the lowest-cost distribution channel is still the airlines' own websites and it should not be forgotten that prior to Orbitz, airlines did *not* consistently offer webfares through any online agency. Orbitz charter associate airlines have retained tools, such as frequent flyer promotions for bookings on their own websites, to enhance the appeal of their airline sites vis-à-vis Orbitz. If the MFN clause were removed from the agreement, it is possible that airlines would once again only offer webfares through their own sites. If so, it is also possible that those own-website only fares would be lower than those that today must also be offered to Orbitz. If that were the case, online agencies such as Travelocity and Expedia would not be guaranteed access to the fares they claim the MFN provision is keeping from them.

If the MFN provision were revoked and airlines believed they would lose revenue by *not* continuing to offer webfares through online agencies (and this is possible as consumers are being educated and encouraged by the airlines, and the online agencies themselves, to search online sites for low fares), they would probably continue to do so. If that were the case, they would likely offer webfares only through the online agency or agencies providing the airlines with the highest revenues net of distribution costs. Competition to gain access to these webfares could increase, as could the proclivity of airlines and online agencies to engage in exclusive arrangements. Orbitz maintains, however, that it relies on the MFN provision to guarantee its access to webfares without the pressure to conclude override agreements that would threaten its contractual commitment to unbiased displays.

Online agencies argue that they promote airline competition by providing carriers advertising and other "screen presence" opportunities to market their services on their agency websites. They argue that such marketing arrangements have contributed to increasing market share for smaller airlines vis-à-vis their larger competitors. One GDS contends that booking data show that smaller carriers in fact have a greater share of total bookings on other online agencies than they do on

[24] The Forrester Report, *Travel: Direct Connect Isn't Enough*, p. 19.

Orbitz. The limited data submitted to the Department by that GDS are insufficient to support such a conclusion. One low-fare carrier reports that its share of bookings on Orbitz is representative relative to the carrier's overall market share and Orbitz's size. Another low-fare carrier notes that the ability to run promotions on all major online agencies is important to its distribution strategy. A third low-fare carrier observes that lowering distribution costs is critical and, as the carrier keeps pressing for better terms in the face of rising distribution costs even online, it may have to strike a comprehensive exclusive marketing deal with only one of the larger online agencies to achieve substantial cost reduction. The carrier further expresses concern with the level of GDS fees.

National Airlines, a small low-fare carrier, states that, "...by providing an unbiased display of all airline flights and fares, Orbitz allows us for the first time to have a fair shot and gives consumers what they want: a comprehensive and unbiased listing of their travel options." National Airlines also notes that "Orbitz is creating a downward pressure on booking fees that has never existed before, pressure that is resulting in savings for big and small airlines alike and that will be, to a certain extent, passed on to air travelers."[25]

The Online Agency Perspective

From the perspective of online travel agencies, webfares are important because they are, or are perceived to be, significantly lower than other fares and they attract traffic to the sites and drive higher conversion ratios (the percentage of consumers who purchase an airline ticket compared to those who simply look). One major carrier notes that its analysis shows that webfares are perceived to be dramatically cheaper fares, but are not. The additional discount is simply sharing a portion of the distribution cost savings with the customer. The same or even additional restrictions are included in exchange for a lower price. Some airlines maintain that webfares do not undercut corporate travel programs since they are heavily restricted and similar fares are available in the GDSs. One carrier believes that published fare sales with accompanying online incentives are the primary drivers of channel shift and that online incentives associated with published fare sales drive the vast majority of revenue booked through various websites.

"Webfares," or "E-fares" as they were most generally referred to prior to Orbitz, were defined as fares available only on the airline's own website and were offered only on last-minute weekend trips. With the launch of Orbitz, although not necessary due to the launch of Orbitz, the definition of "webfare" began to expand, as did the amount of inventory available to the general public. As it stands today, the only common denominator in airlines' diverse definitions of "webfare" is that it refers to one or more fares available on its own website and not available for purchase through the airline's reservation center or other non-web based distribution channels. To the consumer, however, names like "webfare," "e-fare," and "supersavers" are synonymous with "lowest fare" and attract them to shop on a website that offers them.

The preponderance of webfares is a significant factor in determining whether and the extent to which other online agencies are harmed by airline reluctance to give them full access to webfares. The greater the volume of webfares, the more difficult it will be to attract price-sensitive customers to websites with limited or no ability to sell them. When the Department last publicly commented on its monitoring of Orbitz,[26] webfares (or weekend webfares as they were then

[25] Letter of Michael J. Conway dated April 16, 2001, addressed to Secretary Norman Y. Mineta, p. 2.
[26] DOT letter signed by Susan McDermott and Samuel Podberesky addressed to Jeffrey Katz dated April 13, 2001, p. 7.

commonly known) accounted for only a small proportion of total inventory available for sale – reportedly less than one tenth of 1% of all fares an airline offers. Webfares were, at that time, normally made available only a few days before flight time, only on flights which had an unusually high number of empty seats, and were available for sale only on a carrier's own website. They were rarely available in most markets, were not predictable, and were offered at prices so low that airlines typically wanted to distribute them through the lowest-cost channels possible. While the latter condition still applies, the former conditions have changed significantly in that webfares are now substantially more prevalent in the marketplace, making access to these fares even more important to Orbitz's competitors. There may be several explanations for this. The economic downturn followed by the terrorist attacks of September 11th caused airlines to discount much more inventory in order to attract customers and to do so at minimal cost. The trend in webfare availability, however, has not been stable throughout the period. The launch of Orbitz (and various promotions of the Orbitz participants) coincided with the decline in travel through the summer of 2001. The September 11th disaster followed closely thereafter. During the spring of 2002, it appears that webfares are beginning to stabilize at lower levels, but as carriers add capacity back into the market, restoring service cut in the wake of September 11th, the quantity of webfares offered may spike up once again.

The data routinely reported to the Department do not allow us to determine how many tickets sold industry-wide were sold at webfares. PhoCusWright reports that webfares represent less than 2% of an airline's total ticket sales.[27] Anecdotal evidence obtained as part of our efforts to monitor Orbitz suggests that tickets sold at webfares, including opaque webfares, vary widely by carrier and month. One carrier notes that they roughly account for about 4% of its passengers, while another carrier reports that they represent 6% of its passenger revenue. Another carrier's webfares (including opaque fares) represented 2.7% of revenue and 7.2% of passenger segments for the period January 2001 through February 2002. A third carrier reports that, excluding opaque webfares, published webfares account for an average of 2% of system-wide tickets of the past 14 months and 2.5% of system tickets since June 2001. A fourth carrier notes that webfares available for purchase on its own website (excluding opaque fares, which are not available on its own website), but not available through its reservations agents, make up less than 5% of the carrier's total online sales and less than 1% of its overall sales.

The percentage of tickets sold at webfares is highly variable and dependent on a number of market and carrier-specific conditions. Despite their relatively low share of total tickets sold through all distribution channels, they account for a higher percentage of fares booked online. Webfares are clearly important in attracting customers to a website. It is unclear whether the number of webfare tickets sold as a percentage of total tickets sold will stabilize at current levels, increase, or decrease.

Conclusion

The Department of Transportation has identified three principal questions raised about Orbitz: 1) whether Orbitz (and particularly its MFN provision) substantially reduces charter associate carriers' incentives to offer low fares through other online travel agencies, even if these agencies match the terms offered by Orbitz; 2) whether the owner (and other charter associate) carriers could use Orbitz as a vehicle for price and/or service collusion or coordination and thereby reduce

[27] *Airline Web Sales Soar Despite Sour Year*, PhoCusWright, Inc., May 2002, p. 3.

competition; and, 3) whether Orbitz has achieved a dominant position in the online agency business and threatens the ability of other online agencies to compete. The observations in this report illustrate the issues and developments under consideration in making determinations on each of these three primary issues from the perspective of the Department of Transportation.

By its very existence as part of a new and integrated business model, the Orbitz MFN provision has clearly affected the marketplace. The challenge for the DOT is to definitively determine its effect on the marketplace in light of legal standards under 49 U.S.C. 41712 which incorporate antitrust laws and antitrust principles. To date, Orbitz has had some pro-competitive effects in the marketplace and has brought some benefits to consumers. Orbitz could, however, evolve in ways that could harm airline competition and the potential for concern still exists. In particular, the Department is concerned about the potential that the Orbitz MFN provision could discourage selective discounting and other direct marketing initiatives through various distribution channels. Although Orbitz appears to be committed to continually reducing its distribution costs, charter associates may be reluctant to offer a greater quantity of low-fare products given their obligation to also place them on Orbitz, since Orbitz's distribution costs – while low – are higher than carriers' own websites. Furthermore, although Orbitz claims that the MFN provision requiring airlines to give Orbitz fares that it offers third-party online travel provider websites even if it does not offer these fares on its own website (provided that Orbitz can match the terms of those agreements) has not been invoked, airlines may change their distribution strategies and seek to offer such deals exclusively to third parties. In this and perhaps other instances, the MFN clause could potentially have a negative effect on airline competition.

Reaching any determination in this area is complicated by the fact that both the airline and the online travel agency businesses are changing very rapidly. Businesses in both sectors are fundamentally re-evaluating both the revenue and the cost sides of their businesses due to changes in the travel industry since September 11th. Government intervention in the marketplace should be designed to correct a failure of market forces, not to replace or pre-empt them in ways that could potentially stifle innovation.

The Department will continue to consult with the Justice Department as we monitor and evaluate concerns about Orbitz in the context of rapid changes in the airline distribution business. In the meantime, the Justice Department will complete its antitrust review of Orbitz. Because that review has not been completed, we refrain from reaching definitive conclusions in this report on the effects of Orbitz on competition in the airline and airline distribution businesses.

APPENDIX: ORBITZ CHARTER ASSOCIATE AIRLINES (as of March 31, 2002)

U.S. AIRLINES

Alaska Airlines
Aloha Airlines
American Airlines
Continental Airlines
Delta Air Lines
Hawaiian Airlines
Midway Airlines
Midwest Express
National Airlines
Northwest Airlines
Spirit Airlines
United Air Lines
US Airways

FOREIGN AIRLINES

AeroMexico
Air France
Air Jamaica
Air New Zealand
All Nippon Airways
Asiana Airlines
Cathay Pacific
China Airlines
COPA Airlines
CSA Czech Airlines
El Al Israel Airlines
EVA Air
Finnair
Iberia Airlines
Japan Air Lines
KLM Royal Dutch
Korean Air
LanChile
LanPeru
LOT Polish Airlines
Lufthansa
Mexicana Airlines
Qantas Airlines
Scandinavian Airlines
Singapore Airlines
South African Airways
Uzbekistan Airways
VARIG Brasil
Virgin Atlantic Airways

Appendix C

U.S. Department of Transportation
Office of the Secretary of Transportation
Office of Inspector General

Memorandum

Subject: INFORMATION: OIG Comments on DOT Study of Air Travel Services, Office of the Secretary CC-2002-061

Date: December 13, 2002

From: Kenneth M. Mead
Inspector General

Reply to Attn. of: JA-50

To: The Secretary
The Deputy Secretary

This report presents the results of our review of the Department of Transportation (Department) Study of Air Travel Services. On June 27, 2002, the Office of Aviation and International Affairs issued a report to Congress on its efforts to monitor air travel services related to Orbitz. The Office of Inspector General (OIG) was directed by the House and Senate Transportation Appropriations Subcommittees in the Conference Committee Report on the DOT Appropriations bill for Fiscal Year (FY) 2002[1] to evaluate and comment on the Department's findings.

We have reviewed the Department's report and evaluated the reasonableness and accuracy of the Department's analysis and conclusions. We selectively verified data cited in the report to the information submitted to the Department by Orbitz' airline-owners, Charter and non-Charter Associates,[2] Global Distribution Systems (GDSs), and online travel agencies. In addition, we held discussions with and reviewed supplemental data submitted by online and brick-and-mortar travel agencies, Department officials, GDSs, and large and small carriers. We also conducted tests of online travel agencies to determine the validity of some of the claims Orbitz' critics have made.

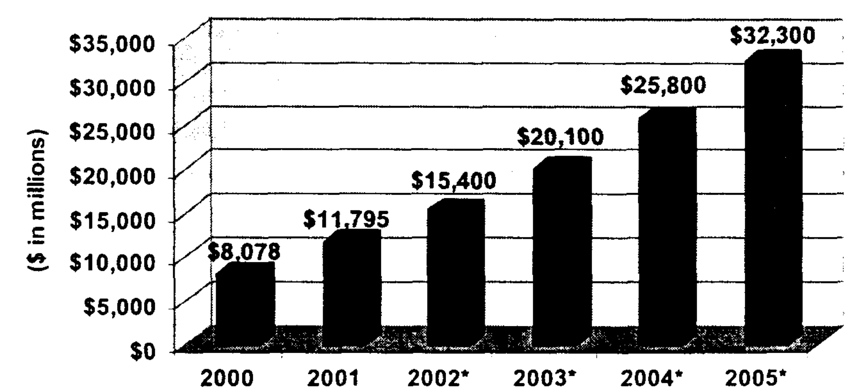
[1] House Report 107-308, Making Appropriations for the Department of Transportation and Related Agencies for the Fiscal Year Ending September 30, 2002 and for Other Purposes.
[2] Orbitz' owners and other airlines that chose to enter into a contractual relationship with Orbitz related to booking fee rebates and access to certain fares are referred to as Charter Associate airlines. Non-Charter Associate airlines are those airlines that were invited, but declined to enter into a contractual agreement with Orbitz.

Several negotiations and other activities were in process at the time the Department conducted its review and the Department could not fully evaluate their impact on the industry. Some of these activities have subsequently been finalized and we have included them in our analysis and report.

INTRODUCTION

Since the late 1990s, the Internet has claimed an increasing share of the travel sales market as both travel suppliers and consumers recognize the potential for substantial savings—in distribution costs for suppliers and prices for consumers. Between 2000 and 2001, airline ticket sales over the Internet increased by 46 percent and are expected to increase again in 2002 by another 31 percent. Currently, about 15 percent of all airline tickets are sold over the Internet. Figure 1 illustrates the past and projected growth of airline tickets sold online through 2005.

Figure 1. Past and Projected Growth of Airline Tickets Sold Over the Internet, 2000 Through 2005



Source: PhoCusWright, May 2002

* Projected

In November 1999, four of the largest U.S. airlines announced their intent to jointly launch an online travel agency, a venture they ultimately named "Orbitz."[3] At that time, consumer groups, Congress, government agencies, and industry stakeholders voiced concerns about the possible antitrust and anticompetitive issues associated with this collaborative effort among competitors. The primary concerns were:

- The contracts Orbitz entered into with Charter Associate airlines included a Most Favored Nation (MFN) clause. The MFN clause entitled Orbitz to

[3] The original founding airlines included Delta, United, Northwest, and Continental. American Airlines later joined the venture and is also considered a founding airline.

receive any fare made available on a Charter Associate airline's website. It also required Charter Associate airlines to provide Orbitz with any fares they made available to Orbitz' online competitors as long as Orbitz was able to match the terms offered by the competing agency. In exchange, Orbitz committed to substantial Global Distribution Systems (GDS)[4] fee rebates, a schedule of declining airline transaction fees, and to develop the capability to link directly into airlines' internal reservation systems. Opponents argued that the MFN clause would result in the airlines acting in an anticompetitive manner by not sharing their fares with distribution outlets other than Orbitz.

- Orbitz committed to neutrally displaying all airfares, regardless of whether or not an airline had an ownership interest or had signed a Charter Associate agreement with Orbitz. Concerns were raised that Orbitz' airline owners would skew displays to give preferential display to their own fares.

In July 2000, we testified before the Senate Commerce Committee on our initial review of the above concerns.[5] We stated that in the long term, barring any anticompetitive behavior, Orbitz could generate competitive pressure on other online agencies to eliminate bias and upgrade search capabilities. Orbitz could also put competitive pressure on GDSs to lower booking costs and improve services.

However, we also noted Orbitz' potential for harmful impacts on the travel marketplace. We cautioned that if Orbitz were extremely successful and eliminated its online competitors, it could develop the power to charge premiums to airlines to participate, benefiting its equity owners to the detriment of other airlines and resulting in higher fares to consumers. We encouraged the Departments of Justice and Transportation to evaluate the likelihood of these and other scenarios playing out in determining whether prior intervention was needed to protect competition and consumers.

In April 2001, as a result of an informal investigation, the Department of Transportation issued a letter to Orbitz indicating that it would not prevent Orbitz from beginning operations or require it to change its business strategy. The Department advised, however, that it would continue to monitor Orbitz to ensure

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[4] A Global Distribution System is a computer system that allows subscribing travel agents to search for and book airline reservations for their clients. Airlines must pay a transaction fee for every booking made through a GDS. The terms Computer Reservation System (CRS) and GDS are often used interchangeably, but a CRS technically refers to one airline's internal reservation system. All GDSs were formerly CRSs, and were all started as individual airline systems that were later expanded to include the fare and service offerings of all participating airlines.

[5] CR-2000-111, July 20, 2000. *Internet Sales of Airline Tickets*, Office of Inspector General, U.S. Department of Transportation.

that its actual operations did not harm consumers. In June 2001, Orbitz launched and has remained the subject of ongoing scrutiny. The Conference Report that accompanied the FY 2002 Department of Transportation Appropriations Act required the Department to report on its monitoring efforts of Orbitz and to provide its report to our office for review. This memorandum conveys the results of our review.

In addition, in April 2000, Congress established the National Commission to Ensure Consumer Information and Choice in the Airline Industry (the Commission) to examine the market position and overall state of retail travel agents for the sale of air travel services.[6] The Commission held hearings in June and July 2002 to determine whether the financial condition of travel agents was declining; whether airlines were creating barriers to information regarding their services and products; and whether consumers, travel agents, and online travel distributors were being affected by the changes in the travel marketplace.

The Commission's November 13, 2002 report found that consumers have benefited greatly from the changes in travel distribution, including more efficient access to travel information as a result of the Internet. However, the picture is less rosy for travel agents, who have faced consolidation and downsizing in the wake of shrinking commissions, growth of sales via the Internet, and reduced travel spending tied to the recession and the post-September 11, 2001 environment.

While concerned about these impacts, the Commission did not recommend new legislation or regulations, noting that the Government as a rule does not intervene in how suppliers distribute their products; nor does it shield private businesses from downward swings in the business cycle or from marketplace shifts in demand for their services. The Commission did not support mandating that webfares be made available to all distribution channels, noting that airlines have traditionally segmented fares among various distribution channels, and that the harms to consumers from such a policy would likely outweigh the benefits derived by travel agents.

However, the Commission recommended that the Government consider whether Orbitz should be allowed to maintain its MFN clause. The Commission cited concerns about Orbitz' potential for artificially inhibiting competition which would result in less competition among travel web sites, fewer "special deals" outside of Orbitz, and higher airfares to consumers. The Commission also stated that it found no aspect of Orbitz' business or goals that require the MFN or which justifies its existence.

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[6] Congress established the Commission as part of the Aviation Investment and Reform Act for the 21st Century (AIR-21).

RESULTS IN BRIEF

We agree with the Department's finding that Orbitz' operations have been consistent with its original plans and that it has adhered to its business model. Orbitz has entered into agreements with airlines that guarantee reduced distribution costs in exchange for access to the airlines' webfares. Orbitz has also made progress with its plans to establish direct links into the airlines' own reservation systems. We also concur with the Department that Orbitz has adhered to its commitment to an unbiased display of airfares and services.

However, one element of Orbitz' business plan that has not come to fruition is the planned public stock offering. Orbitz contends that the introduction of minority shareholders will dilute the airline ownership of Orbitz and thus mitigate concerns regarding a joint venture formed by competitors. The currently planned structure of the company following the public offering will not provide minority shareholders with sufficient powers to institute checks and balances on the actions of the airline-owners, and is therefore not an adequate substitute for continued monitoring of this joint venture.

The Department did not draw conclusions on the anticompetitive effects of Orbitz' MFN clause because of the Department of Justice's ongoing review. Based on our review, we did not find substantive evidence to indicate that the MFN clause has resulted in monopolistic or anticompetitive behavior by Orbitz' airline-owners and Charter Associates. With about 24 percent of the online travel agency air market, Orbitz has not accumulated sufficient market share to control the online distribution market. Orbitz' ability to gain additional market share is limited by several factors including its consumer ticketing fees and the fact that some airlines have chosen not to become Charter Associates.

In our tests of online ticket distribution sources, we found that nearly every advantage Orbitz demonstrated in finding or matching the lowest fares was negated by the \$5 to \$10 ticketing fee Orbitz charges consumers. While Orbitz offered or matched the lowest *fare* in 76 percent of our tests, once the ticketing fee was added, Orbitz offered the lowest *price* to consumers in only 3 percent of the tests. It is important to note that at the time of our tests (November 2002), neither Expedia nor Travelocity had yet instituted consumer ticketing fees. Since our testing, Expedia has begun implementing a \$5 consumer ticketing fee on most domestic fares and Travelocity has announced that it will also institute a similar fee beginning early next year. In 24 percent of tests where Orbitz did not find or match the lowest fare, it was primarily because the lowest fare in the market for that itinerary was offered by non-Charter Associate airlines that typically reserve their lowest fares for their own websites. In approximately 4 percent of our tests, Orbitz had access to a significantly better fare than its competitors, although nearly half of these were attributable to itineraries that its competitors did not display.

We also found that a significant percentage of the lowest fares was offered by non-Charter Associate airlines *only* for purchase on their own websites. To the extent that non-Charter Associate airlines continue to offer lower fares exclusively on their own websites, the airlines undermine Orbitz' ability to gain market power.

Further, we found evidence that Orbitz' airline-owners and Charter Associates are increasingly providing Orbitz' competitors access to their webfares when distribution cost savings are offered. Webfares—or airfares that are available for sale only over the Internet—constitute a small percentage of fares that are offered for sale at any given time, but travel agencies have stressed the importance of having access to webfares in order to attract consumers to their websites. In August 2002, our tests to determine which agencies had access to deeply distressed weekend webfares found that all of the top three online travel agencies had access to at least some of the webfares, although the degree of access varied significantly.

In recent months, new agreements that guarantee webfare access have been signed between the airlines and Orbitz' online competitors. In addition, one major Charter Associate airline has signed agreements with two GDSs that will also make its webfares available to all online and brick-and-mortar travel agents using those respective systems. Orbitz' competitors have complained that they have had to offer better terms than Orbitz to access these webfares; however, this was difficult to evaluate because of the contingent structures of the agreements. Many involve market share-shifting override incentives that could result in terms that are either better or worse than the Orbitz deal, depending on whether market-shifting targets are met.

1. Whether Orbitz' operations have been consistent with its plans and whether Orbitz has adhered to its business model.

Orbitz' business model included developing contractual "Charter Associate" relationships with airlines that require the airlines to provide access to their most discounted published inventory in exchange for significant savings on distribution costs.[7] The contractual agreements commit to a gradually declining schedule of transaction fees that Charter Associate airlines pay Orbitz for every ticket sale. Orbitz' charter agreement also commits to neutral display of all airfares, regardless

[7] Orbitz has signed Charter Associate agreements with 42 airlines, 5 hotel companies, and 7 rental car companies. The focus of this review was on the airline ticket distribution portion of Orbitz' operations. A list of the Charter Associate airlines is provided in Exhibit B.

of whether or not the airline has invested in Orbitz or signed a Charter Associate agreement. Orbitz' airline-owners launched the website as a privately-owned entity, but planned to eventually dilute the airline ownership through a public stock offering.

The Department concluded that Orbitz' operations have been consistent with its plans and that Orbitz has adhered to its business model. We agree generally with this finding, although Orbitz has delayed its public stock offering because of Government scrutiny and the unfavorable stock market environment.

Concerns continue to linger regarding Orbitz and the idea that the five largest airlines have created a joint venture for ticket distribution. The Department of Justice, the Department of Transportation, and our office reviewed Orbitz' plans prior to its launching, as well as its operations since that launch in June 2001. While no tangible harms have been proven to date, many of Orbitz' opponents are still skeptical of the airline-owners intentions.

Orbitz has contended that taking the company public will introduce minority shareholders that could eliminate some of the ongoing need for intense Government scrutiny by providing some internal checks and balances against the possibility that the airline-owners could use Orbitz to harm the marketplace. *On its face, diluting airline ownership should help to assuage some of the concerns over Orbitz' control issues. In our view, however, this approach will do little in substance to mitigate the ownership and control issues because the proposed structure of the public company essentially places all operating decisions in the hands of the airline-dominated Board of Directors.*

Orbitz believes that such control is necessary to preserve several pro-market elements of its business plan, including nonbiased displays of airfares and services, and commitment to being a distribution outlet price competitor. According to Orbitz, these elements are pro-consumer, but may run contrary to the financial interests of non-airline shareholders. This may be correct; however, the proposed structure of the public company, as it stands, does not provide an adequate substitute for Government oversight of Orbitz and its owners.

2. Whether Orbitz has adhered to its contractual commitment to an unbiased display of fares and services.

The Department concluded, and we concur, that Orbitz has not deviated from its commitment to an unbiased display of airfares and services. The issue of industry display bias was first raised in the late 1970s and early 1980s when *individual* airlines owned the Computer Reservation Systems (CRSs) used by travel agents to access data on fares and services of nearly *all* airlines. The airlines skewed—or biased—the screens viewed by the travel agents in favor of their own products and services. While regulations now prohibit screen bias for integrated CRS displays of fares and services, the regulations do not extend to how online agencies then relay information on fares and services to their customers.

Commission override agreements, which provide incentive payments based on an agency's ability to shift market share to a particular carrier, are still prevalent in the industry. Online agencies have various techniques for highlighting and promoting airlines with which override agreements have been negotiated. *When Orbitz incorporated in 2000, it committed to an unbiased display of all fares and services regardless of whether or not an airline had become a Charter Associate or invested in Orbitz. To date, we have seen no evidence to suggest that Orbitz has deviated from this commitment.*

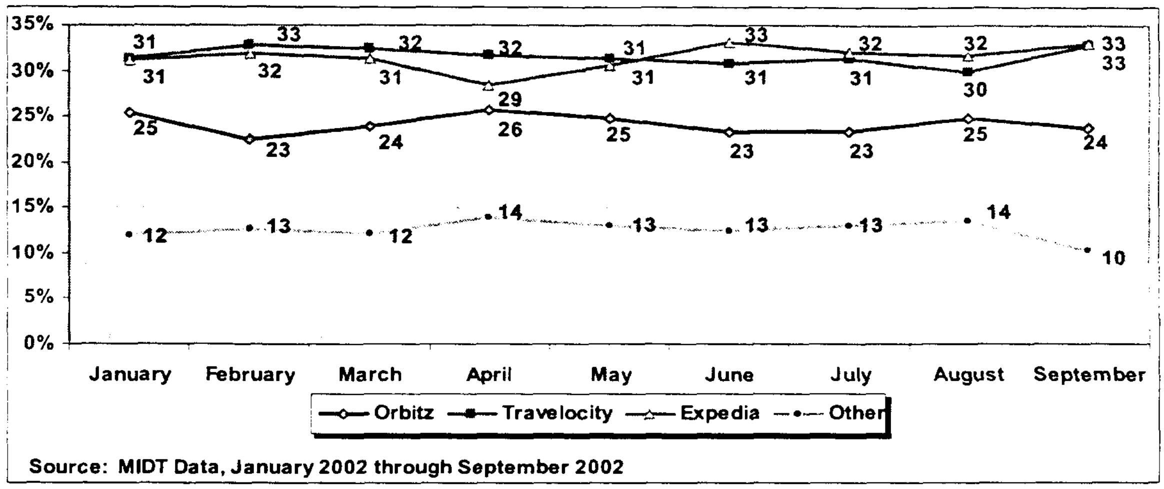
3. Whether the MFN clause has resulted in Orbitz' airline-owners and Charter Associates engaging in monopolistic or anticompetitive behavior.

We selectively reviewed the extensive data provided to the Department, interviewed industry stakeholders, and conducted our own tests of online distribution sites. Based on our review, we did not find substantive evidence to indicate that the Orbitz MFN clause has resulted in monopolistic or anticompetitive behavior by Orbitz' airline-owners and Charter Associates.

First, in order for Orbitz to exercise market power, it must first accumulate a dominant market share and it has not done so. After an initial period of rapid growth, Orbitz has maintained a steady market share for Internet travel agency air sales of about 24 percent, lagging behind both Expedia and Travelocity. Figure 2 illustrates the air market share of Travelocity, Expedia, Orbitz, and other online agencies between January and September 2002.[8]

[8] The "other" category includes online travel agencies such as Cheaptickets.com and GetThere.com that sell airfares in a predominantly non-opaque manner. Excluded are opaque sites such as Hotwire.com and Priceline.com.

Figure 2. Average Monthly Air Market Share of Online Agencies, January Through September 2002*



* Orbitz implemented Supplier Link technology with American Airlines in mid-August 2002. American's air bookings through Supplier Link are not reflected in the Marketing Information Data Transfer (MIDT) data and are not represented in Orbitz' overall air market share data for August and September 2002.

Second, even though Orbitz' Charter Associates provide access to low fares and give Orbitz an opportunity to gain a marketplace advantage over its competitors, Orbitz' consumer ticketing fees often negate that advantage. In November 2002, we selected a statistical sample of 251 airport-pairs from a universe of 3,027. We performed two tests in each market—one with a typical business travel itinerary, and one with a typical leisure travel itinerary. With a sample size of 502 tests, we can be 90-percent confident that the margin of error of our estimates is no larger than 4.9 percent. A table with detailed results showing confidence limits and margins of error is included in Exhibit A.

We found that while Orbitz offered or matched the lowest *fare 76 percent* of the time,[9] more often than not, the *price*—or cost to consumers to purchase that fare—was higher than its competitors once Orbitz' fee was added. *Orbitz charges a consumer ticketing fee of between $5 and $10 for all tickets purchased on Orbitz. When this fee is added to the airfare, the total cost to the consumer—or price—was lowest on Orbitz in only 3 percent of our tests. Almost 97 percent of the time, consumers could have paid less for the same airfares on one or more of Orbitz' competitors' websites or on an airline's own website.*

Although Orbitz displayed the lowest fare in a majority of our tests, its ticketing fee often negated this advantage. At the time of our testing, Orbitz was the only one of the top three online agencies that charged a consumer ticketing fee. Since

[9] In the 24 percent of tests where Orbitz did not display the lowest fare, that fare was primarily offered by a non-Charter Associate airline that was only making that fare available for sale on its own website.

our tests, Expedia has implemented a $5 fee on most domestic sales of airline tickets. In addition, Travelocity recently announced that it too will institute a similar fee beginning early next year. The fees and any others charged to consumers in the future by Orbitz' competitors would likely minimize the differences we found between Orbitz' performance and that of its competitors.

In addition, we found that in most of the tests where Orbitz offered a significantly better fare than its competitors, it was not because of the MFN clause. Orbitz' search engine was able to splice together fares from multiple carriers or find fares from non-Charter Associate airlines, such as AirTran or American Trans Air, that are not bound by the MFN clause to provide Orbitz their lowest fares.

Orbitz' ability to gain market power by having access to the lowest fares in the marketplace will likely continue to be limited by airlines, such as Southwest and JetBlue, that have substantially lower fares in some markets but choose not to enter into Charter Associate agreements with Orbitz. In many cases, the lowest fares from these airlines will appear only on their own websites, and to some extent, on other online agency websites that agree to shift market share in exchange for access to low-fare inventory.[10] In our November 2002 tests to determine which agencies had access to the lowest fares, we found that in the 24 percent of the 502 tests where Orbitz did not find or match the lowest fare, the reason was primarily because the lowest fare in the market for that itinerary was offered by a non-Charter Associate airline on its own website. To the extent that these non-Charter Associate airlines continue to offer lower airfares only on their own websites or through special deals with Orbitz' competitors, Orbitz will be precluded from gaining access to a significant share of the low-fare market.

4. Whether Orbitz' airline-owners and Charter Associates were acting in an anticompetitive manner by refusing to provide their lowest fares to Orbitz' competitors.

In addition to making all of their regularly published fares available through standard distribution channels, airlines also make some fares available *exclusively* on the Internet, including their own airline websites and to some extent, third-party agency websites. These Internet-only fares are called webfares because they are available for sale only via the World Wide Web. Generally, webfares constitute a very small percentage of the universe of fares for sale at any given time through an online agency, including Orbitz, Travelocity, and Expedia. Further, weekend

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[10] Most domestic airlines have eliminated domestic base commissions, which provided a commission to travel agents equal to a set percentage of the value of the ticket sold. Airlines have instituted "share shift" agreements, sometimes referred to as travel agent commission overrides, which provide financial incentives to travel agents to sell tickets on an airline disproportionate to its share of the available seat miles in that market. Generally, the greater the share sold, the higher the commission.

webfares, which are deeply distressed inventory offered for sale in selective and varying markets just days prior to travel, represent a small percentage of all webfares. However, despite their relatively minor market presence, nearly all travel agencies have stressed the importance of having access to webfares in order to attract consumers.

We selected a judgmental sample of 108 webfares that were offered in August 2002 for last-minute weekend travel to determine which agencies could access those fares. We found that all of the top three online travel agencies had access to at least some of the airlines' weekend webfares, although the degree of access varied significantly. Of the 108 webfares tested, Orbitz had access to 92 (85 percent), Expedia had access to 42 (39 percent), and Travelocity had access to 7 (6 percent).

Since our testing in August 2002, new agreements that grant webfare access have been signed between the airlines and Orbitz' online competitors. Furthermore, one major Charter Associate airline recently signed agreements with two GDSs that grant subscribers of these GDSs access to its webfares, including brick-and-mortar agents, in exchange for reduced booking fees.

In some cases, Orbitz' competitors have complained that they have had to offer better terms than Orbitz to access these fares. We have looked at the terms of a sample of these agreements and believe that while some of the provisions are very similar to Orbitz', including a declining scale of airline transaction fees, there are differences in most of them that make a financial comparison difficult. Most notably, the inclusion of market-shifting override incentives makes the financial terms of the agreements contingent upon what plays out in the market. If certain market-shifting targets are met, the terms of the agreement could potentially provide *better* terms than what the Orbitz deal offers. If the goals are not met, the terms are not as good.

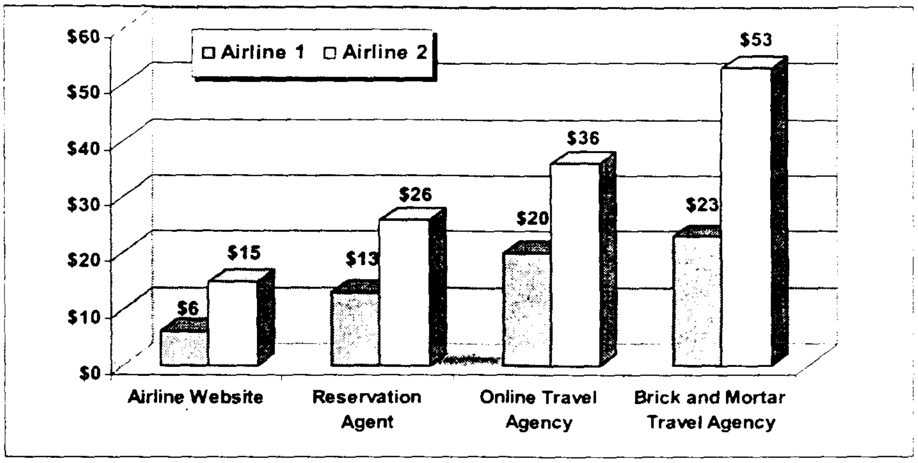
BACKGROUND

Before airline deregulation in 1978, airlines sold more tickets through their reservation call centers and city ticket offices than through any other distribution source. Following deregulation and the resulting explosion of airfare and service options, most airline ticket distribution shifted to brick-and-mortar travel agencies. In recent years, however, reductions in airline commissions along with the proliferation of Internet travel channels have eroded the travel agencies' consumer and economic base as airlines encourage consumers to purchase tickets through less costly distribution outlets. Before the Internet, brick-and-mortar travel agencies sold between 70 and 75 percent of airline tickets; that number is now estimated to be between 50 percent and 70 percent. Online distribution channels include airline websites, online travel agencies, and online consolidators and discounters.

After several generally profitable years, the airline industry lost approximately $8 billion in 2001. With the recent airline economic climate showing few signs of recovery and consumer confidence returning slowly, the U.S. airline industry is expected to report substantial losses in 2002. To reduce losses, airlines have attempted to lower their cost structures and reduce capacity. One area of focus has been ticket distribution costs, the third highest category of costs behind labor and fuel for many airlines, as a means of controlling overall cost growth. In March 2002, most major airlines eliminated travel agent base commissions. Nevertheless, the GDS fees incurred with travel agent bookings combined with override commissions or other ticketing fees continue to make this distribution outlet relatively costly for airlines.

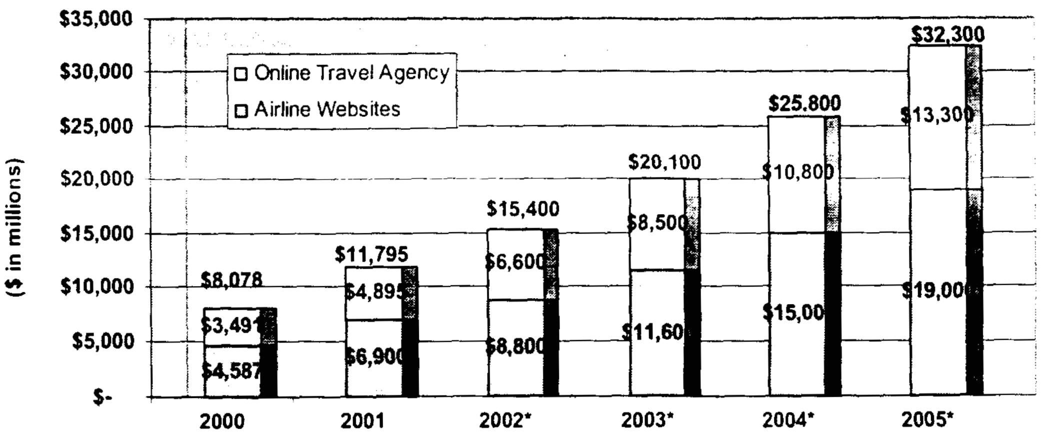
Airlines incur the lowest ticket distribution costs on their own Internet websites. Airlines have encouraged consumers to purchase tickets on the Internet by making special fares—sometimes referred to as "e-fares," "webfares," or "web-only" fares—available for purchase only on the Internet. Figure 3 illustrates distribution costs from two major carriers in 2000. Although the absolute costs reported for each distribution channel differ substantially between the two carriers, the relative costs per channel follow the same pattern.

Figure 3. Per Ticket Distribution Costs for Two Major Carriers in 2000



Currently, about 15 percent of all airline ticket sales revenue is from sales over the Internet, which is nearly double the 8 percent of all airline ticket sales revenue in 2000. Of the 15 percent sold online, about 42 percent of tickets were sold through third-party sites, such as Expedia, Travelocity, and Orbitz, and 58 percent were sold through the airline websites.[11] In 2001, airline website revenues increased 50 percent over 2000 to $6.9 billion. Figure 4 illustrates the growth of airline ticket sales over the Internet.

Figure 4. Airline Internet Ticket Sales, 2000 Through 2005*



Source: PhoCusWright Inc, May 2002

* Actual sales are reported for 2000 and 2001 and sales are projected from 2002 through 2005.

In June 2001, five major airlines—Delta, United, Northwest, Continental, and American Airlines—launched Orbitz, an online travel agency. Orbitz invited any domestic or foreign airline to become a Charter Associate, which would require the airline to enter into a contractual agreement with Orbitz regarding access to certain fares, marketing support, and booking fee rebates. To date, Orbitz has 42 airline Charter Associates, including Orbitz' airline-owners. According to the airline-owners, Orbitz was created to apply pressure on rising GDS distribution costs. Consistent with its business model, Orbitz has begun implementing Supplier Link,[12] which enables Orbitz to access an airline's internal reservation system directly, thus bypassing the GDSs.

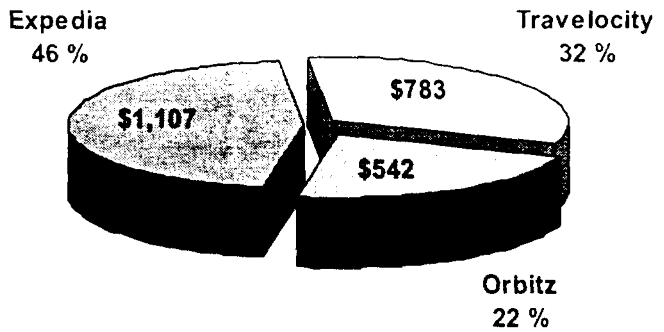
As part of its business model, Orbitz has also committed to displaying each airline's fare and service information without bias, regardless of whether the airline has opted to become a Charter Associate. To provide continued cost savings to the Charter Associates, Orbitz committed to a declining distribution cost schedule, including gradually diminishing transaction fees paid by the airlines and continued implementation of Supplier Link technology.

[11] Figures based on May 2002 PhoCusWright report and Gary Doernhoefer's June 2002 testimony before the National Commission to Ensure Consumer Information and Choice in the Airline Industry.

[12] Supplier Link is the term applied to Orbitz' direct connection to an airline's internal reservation system. Reservations made through Supplier Link are not channeled through a GDS and thus avoid all GDS fees.

Since its inception, Orbitz has grown to become the third largest online travel agency behind Expedia and Travelocity, in terms of total travel bookings. Based on the data provided to the Department, in the first quarter of 2002, Expedia's travel bookings totaled $1.1 billion, Travelocity's totaled $783 million, and Orbitz' totaled $542 million (see Figure 5).[13]

Figure 5. Travel Sales and Relative Share of Market for the Three Largest Online Travel Agencies, First Quarter 2002 ($ in millions)



Source: PhoCusWright Inc., May 2002

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to evaluate the reasonableness and accuracy of the Department's analysis and conclusions reached on its monitoring efforts as required by the Conference Report on the DOT Appropriations bill for FY 2002. The conferees requested that the Department evaluate and comment on the following four potential concerns.

- Deviations from plans, policies, and procedures initially proposed in the joint venture's business plan and contained in its charter associate agreements.
- Extent to which the joint venture has adhered to its commitment to not bias displays of fares or services.
- Extent to which ties between the airline-owners and the "Most Favored Nation" clause in the charter agreement have resulted in monopolistic or other anticompetitive market behavior.
- Whether airline-owners of the joint venture or charter associates have acted in an anticompetitive manner by choosing not to distribute fares through other distribution outlets.

[13] Total travel sales include airline tickets, hotels, car rentals, packages, cruises, and other travel-related products.

We examined the Department's June 27, 2002 report and selectively reviewed data submitted to the Department by Orbitz' airline-owners, Charter and non-Charter Associates, GDSs and online travel agencies. We held discussions with and reviewed supplemental data submitted by online and brick-and-mortar travel agencies, Department officials, GDSs, and large and small carriers. We also reviewed industry analyses from widely recognized Internet experts, such as Forrester Research and PhoCusWright, Inc., to evaluate trends in the online travel environment.

We independently designed two sets of tests of online ticket distribution to provide us with additional data to help evaluate: (1) whether Orbitz' MFN clause has resulted in anticompetitive behavior by its airline-owners or whether the MFN clause has given Orbitz a significant marketplace advantage and (2) whether Orbitz' airline-owners are restricting the distribution of their webfares exclusively to Orbitz and their own websites.

We began Test 1 in the summer of 2002 by selecting a preliminary statistical sample of 110 airport-pairs from a universe of 3,027. We divided the 110 airport-pairs and tested 55 markets using itineraries with parameters typical of business travelers and 55 markets using itineraries with parameters typical of leisure travelers to determine how many times a website found or matched the lowest fare or price. In order to improve the precision of our results, we expanded our review in November 2002 to include another statistical sample of 251 airport-pairs. We performed two tests in each market—one with a business itinerary, and one with a leisure itinerary, for a total of an additional 502 tests. Table 1 identifies the parameters used in our tests to distinguish between a typical "business" itinerary and a typical "leisure" itinerary.

Table 1. Business and Leisure Itinerary Parameters

Parameters	Business	Leisure
Connections	Non-stop 1-Stop	Non-stop 1-Stop 2-Stop
Layover	3 hours	5 hours (each)
Travel Times	Depart: No earlier than 5:50 a.m. Arrive: No later than 12:10 a.m.	Depart: Any Arrive: Any (Overnight travel permitted)
Restrictions	No Saturday stay	7-day minimum stay, Saturday night stay
Advance Purchase	2-3 day	21 day

To conduct the tests, we simultaneously accessed the top three online travel websites, Charter Associate airline websites, and the websites of any non-Charter Associate airline serving that market. Fares were noted including all taxes, security, and airport fees. Any additional fees—such as consumer service fees or fees for issuing paper tickets—were identified separately. Results were analyzed on a "fare-only" basis as well as a "fare+fee" basis to determine the actual cost of the product to consumers.

We found that our second sample verified the results of our first. We can be 90 percent confident that the margin of error of our estimates is no larger than 4.9 percent. A table with detailed results showing confidence limits and margins of error is included in Exhibit A.

In Test 2, we selected a judgmental sample of 108 webfares offered for sale by eight Charter Associates, including the five founding airlines. We selected between 12 and 15 weekend webfares for the eight airlines that were being offered for travel for the approaching weekend. We simultaneously tested these itineraries on the three major online travel agencies to identify which online agencies had access to this fare inventory. We also simultaneously tested the offering airline's own website to ensure that an agency's inability to display a fare did not reflect a lack of availability.

We also compared a sample of 118 webfares offered in July 2001 to webfares offered in August and September 2002 to determine whether and to what extent average webfares have increased in those markets. The markets were judgmentally selected based on whether a webfare between the two markets was available in both 2001 and 2002. Exhibit A provides a more detailed discussion of our testing methodology.

To evaluate the accuracy of the Department's report, we judgmentally selected statements of facts cited in the Department's report and verified the items to the data, letters, narrative, and interrogatories the Department received from the online agencies, GDSs, and airlines.

RESULTS

Orbitz Has Not Materially Deviated from Its Original Business Plan or Business Model

The Department found that at the time of its report, Orbitz' implementation had been generally consistent with its business plans and business model. We found that this was generally true, although events subsequent to the Department's report, including sustained difficulties in financial markets and continued

Government oversight activity, have caused Orbitz to delay its intended public stock offering.

Some of Orbitz' critics have alleged that the Orbitz business model is fundamentally uneconomic as a viable, independent, ongoing concern. The allegation reflects a belief that Orbitz was never intended to make money and was only established by the airline-owners to force all online travel agencies out of business. Orbitz' competitors claim that Orbitz' pricing model is too low to adequately cover its costs, which is forcing them to offer uneconomic matching pricing schemes in order to gain access to the airlines' best fares. They argue that lowering costs to match Orbitz' offer will force them out of business because they do not have the deep pockets of the airlines to continue to fund sustained losses.

The Department reviewed Orbitz' business plan, its financial statements and projections, and public filings with the Securities and Exchange Commission in anticipation of a public offering, and concluded that the business model is viable. We also reviewed Orbitz' more recent cash flow forecasts and additional financial data, held discussions with Orbitz officials, and essentially concur with the Department's conclusion. In addition, we considered the claims made by Orbitz' competitors and their estimates of the cost of selling tickets through Orbitz. We determined that competitors' cost estimates for selling air tickets through Orbitz were significantly higher than Orbitz' actual costs. Orbitz' competitors' high cost estimates have likely been the genesis of their criticisms of Orbitz' potential for ever making a profit.

Orbitz Has Adhered to Its Commitment to Unbiased Displays of Fares and Services

The Department concluded that Orbitz, to date, has adhered to its contractual commitment to an unbiased presentation of airline fares and services. This commitment prevents Orbitz from accepting traffic-share shifting override commissions from airlines and engaging in preferred carrier relationships similar to those pursued by Orbitz' competitors. We agree with the Department's conclusion that Orbitz has sustained its commitment to unbiased displays. In addition, Orbitz has instituted protections to ensure that such a commitment could not easily be overturned with the introduction of minority stockholders following a public stock offering. To our knowledge only one former Charter Associate airline, which is no longer operating, complained about how its fares were displayed on Orbitz. However, we found no evidence that this was a result of bias. To the contrary, other low-fare airlines including one that is not a Charter Associate indicated that Orbitz' unbiased display makes their lower fares more visible to consumers.

Orbitz' Charter Associate agreements for the non-owner airlines are valid for 3 years from the date originally finalized. Many of these agreements will expire next year. If, at that time, Charter Associate airlines do not believe that Orbitz has treated them fairly, including how their fares and services have been displayed, these airlines may choose not to renew the agreement.

OIG Observations on Orbitz' MFN Clause and Potential for Anticompetitive Behavior by the Airline-Owners or Other Charter Associates

The most controversial Orbitz issue is the so-called MFN clause contained in Orbitz' Charter Associate agreements. The MFN clause requires that Charter Associate airlines provide all fares that they offer on their own websites to Orbitz. It also requires Charter Associate airlines to make any fare that they make available to any other third-party travel distributor available to Orbitz, as long as Orbitz is able to meet the terms offered by the other agency. The MFN clause expressly allows Charter Associate airlines to give the *same* fares it gives Orbitz to other distribution outlets. However, it restricts airlines from giving Orbitz' competitors *better* fares without giving Orbitz a chance to match the terms.

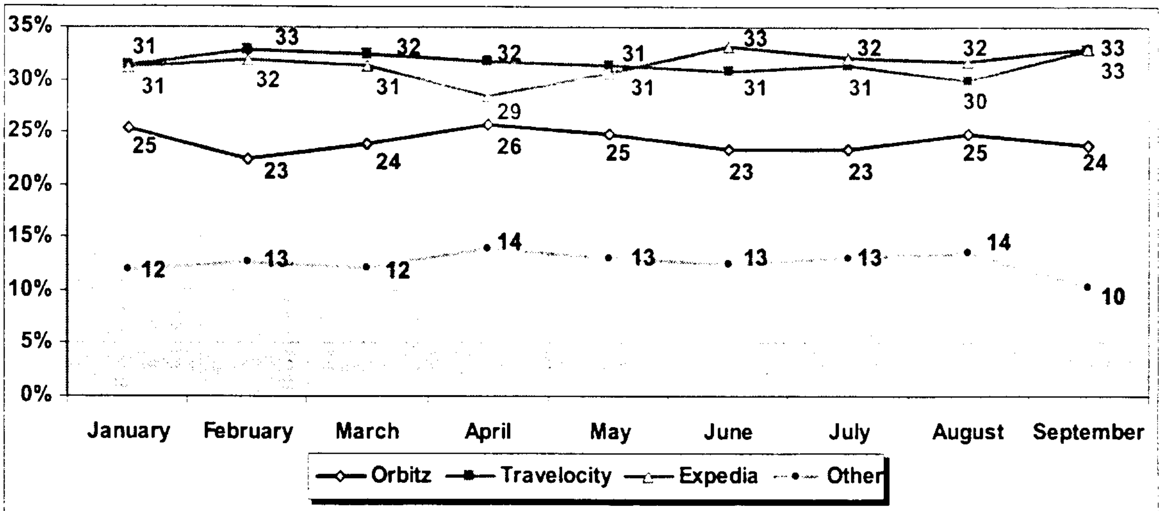
We reviewed data supplied to the Department, conducted interviews with industry stakeholders, and performed our own tests of online ticket distribution sources to determine whether conclusions could be drawn about the impact of Orbitz' MFN clause on the marketplace. A summary of our observations follows.

Orbitz' MFN Clause Has Not Resulted in Sustained Market Share Growth for Orbitz

Orbitz' critics claimed that the MFN clause would give Orbitz exclusive access to its owner-airlines' lowest fares, which would enable it to drive its competitors out of business. Orbitz would then use its market power to charge higher fees to airlines for the privilege of selling through Orbitz, and/or raise the service fee that consumers must pay when they purchase a ticket on Orbitz. Either would ultimately result in higher costs for consumers.

We have found no substantive evidence to date to support claims that Orbitz was gaining and exerting its market power to dominate the online travel industry. In order for Orbitz to exercise market power in this way, it must first accumulate a dominant market share, which it has not done. Although Orbitz is a significant player in the online travel industry, its market share (for air sales only) lagged both Expedia and Travelocity. After an initial period of rapid growth after its launch in June 2001, Orbitz' market share relative to Expedia and Travelocity has stabilized. As Figure 6 illustrates, since January 2002, Orbitz' average monthly air market share ranged from 23 percent to 26 percent, with a 9-month overall average of about 24 percent. Furthermore, recent agreements between Charter Associate airlines and Orbitz' competitors will limit Orbitz' ability to accumulate further market power as its competitors gain access to a wider range of webfares.

Figure 6. Average Monthly Air Market Share of Online Agencies, January Through September 2002*



Source: MIDT Data, January 2002 through September 2002

* Orbitz implemented Supplier Link technology with American Airlines in mid-August 2002. American's air bookings through Supplier Link are not reflected in the MIDT data and are not represented in Orbitz' overall air market share data for August and September 2002.

Orbitz Consumer Ticketing Fees Diminished Most of the Advantages That Resulted When Orbitz Found or Matched the Lowest Fare

Based on our tests, Orbitz found the lowest *fare* significantly more often than its online competitors; however, the $5 to $10 service fee that consumers must pay for booking airfares on Orbitz in many cases closed the *price* gap. When its competitors had access to the same fares, Orbitz was more expensive because of this fee. When Orbitz did provide a significantly better fare than its major online competitors, it typically was not the result of having exclusive access to special fares.

Orbitz Outperformed Competitors in Finding or Matching Lowest Fares. In 502 tests, the $370 average roundtrip fare returned by Orbitz was approximately $11 better than the average roundtrip fare found on Travelocity ($381) and $13 better than the average roundtrip fare found on Expedia ($383). Orbitz found or matched the lowest fare currently available in the tested market on 76 percent of the tests, which was better than Expedia (61 percent) or Travelocity (59 percent).

In 24 percent of tests where Orbitz did not find or match the lowest fare, it was primarily because the lowest fare in the market for that itinerary was offered by non-Charter Associate airlines, such as JetBlue or Frontier Airlines, that typically reserve their lowest fares for their own websites, or Southwest Airlines that does not provide *any* of its fares to online agencies. Table 2 illustrates the results of our 502 tests for access to lowest fares. These fares do not include ticketing fees.

Table 2. Percent of Time Each Site Found or Matched Lowest Fare
(Based on 502 Tests)

Website	Number of Tests	Percent of Time
Orbitz	380	76
Charter Associate Website	345	69
Expedia	305	61
Travelocity	296	59
Non-Charter Associate Website	81	16

Orbitz displayed fares that neither Travelocity nor Expedia displayed in 70 of the 502 tests. In the majority of these tests, the results did not appear to be because Orbitz had exclusive access to significantly lower fares from its Charter Associates. In 52 (74 percent) of the 70 tests, the fare found on Orbitz was within \$6 of the next lowest fare found by another online agency website. Once Orbitz' consumer ticketing fee was added, the marketplace advantage from having the lowest fare all but disappeared. In 11 (2 percent) of the 502 tests that we performed, Orbitz had access to a significantly better fare than its competitors. In another seven tests, Orbitz' search engine was able to combine flight segments by different carriers in ways its competitors could not or did not.

Orbitz' Consumer Ticketing Fee Negated Nearly All Market Advantage of Finding Lowest Fares. Although Orbitz found or matched the lowest *fare* more often than its online competitors, the \$5 to \$10 ticketing fee that consumers would have paid for booking airfares on Orbitz in many cases closed the *price* gap. When Orbitz had access to a fare that was on a carrier's website, it was \$5 to \$10 more expensive for consumers to purchase that fare on Orbitz than by going directly to the airline website. Consumers could also have saved \$5 to \$10 by purchasing on Orbitz' competitors' sites when they had access to the same fare inventory, because neither Travelocity nor Expedia charged fees to purchase airline tickets at the time of our tests.[14] Table 3 illustrates how the websites performed when the actual purchasing price to the consumer was considered.

[14] On December 4, 2002, Expedia began charging a \$5 fee on most airline tickets. Travelocity recently announced that it will institute a similar fee beginning early next year.

Table 3. Percent of Time Each Site Found or Matched Lowest Price to the Consumer (Fare + Fee)
(Based on 502 tests)

Website	Number of Tests	Percent of Time
Charter Associate Website	377	75
Expedia	345	69
Travelocity	336	67
Non-Charter Associate Website	81	16
Orbitz	*17*	*3*

It is notable that consumers appear to be aware of the impact of the fee on the price of tickets. In September 2002, Orbitz' look-to-book ratio[15] (72 to 1) was more than double Expedia's look-to-book ratio. For Orbitz, this means that for every 72 unique consumers that visit Orbitz' website, only 1 makes a purchase. This suggests that a substantial number of consumers use the Orbitz website to research fares but purchase them elsewhere.

Non-Charter Associate Airlines Including Southwest and JetBlue Also Place Limits on Orbitz' Ability to Potentially Dominate the Online Market

Although Orbitz invited every commercial airline to sign on as a Charter Associate, several carriers declined to participate. The largest of the non-Charter Associate Airlines is Southwest, which does not participate in any online agencies. Among other airlines choosing not to sign the agreement are Frontier, American Trans Air, AirTran, and JetBlue. Orbitz has access to the carriers' fares that are filed in Worldspan and ATPCo[16] that can be sold by all travel agents, but these carriers are not subject to the MFN clause which would require the carriers to give Orbitz all fares that they offer publicly, including special deals they make with other agencies or fares they place on their own websites. Some low-fare airlines have been exceptionally successful in attracting consumers to their own airline websites by offering discounts for online purchases. One airline reported to us that website sales represented over 65 percent of its total ticket sales.

Non-Charter Associate airlines' websites returned the lowest fare in approximately 16 percent of our tests. We found that where a market was served by at least one non-Charter Associate airline, the average of the lowest fare offered on a non-

[15] Look-to-book ratios are a prevailing metric in the travel industry that measures the percentage of people who actually buy a product after visiting the travel website.
[16] ATPCo (Airline Tariff Publishing Company) collects and distributes fares and fare-related data for the airline and travel industry.

Charter Associate airline website[17] was $304, which was 24 percent better than the $378 average fare found by Orbitz, Travelocity, and Expedia for those markets.

Orbitz obtains a degree of market advantage by having access to a substantial inventory of the lowest fares. Orbitz has attempted to access all of the lowest fares by pursuing Charter Associate agreements with every operating carrier. To the extent that airlines have chosen not to enter into an agreement with Orbitz and reserved their lowest fares for their own websites or negotiated special deals with other online agencies, these airlines limit Orbitz' ability to increase its market share.

Deeply Discounted Fares Have Changed Little Since 2001

Some of Orbitz' competitors have alleged that the MFN clause would harm the market in the short run by causing airlines to eliminate or reduce the number of webfares they offer on their own websites and/or third-party sites. They argued that the MFN clause, which requires airline-owners and Charter Associate airlines to provide Orbitz with all fares offered through their own websites, would make the lowest fares too visible, thus inviting wide-scale price competition from other carriers in those markets. Rather than invite this competition, the critics argue that airlines will simply not offer these low fares or will not offer them on terms as beneficial to consumers as prior to Orbitz' launch.

We found that the deeply discounted webfares have changed little since 2001. We compared 118 webfares offered for weekend travel during one week in July 2001 to webfares offered for comparable itineraries in 2002. We could not compare the *quantity* of seats available at these fares, since the airlines do not disclose how many seats are available at the advertised fares, with the number available in 2001, but we did look at the *qualitative* aspects—how the fares compared in various market-pairs in 2001 (immediately following Orbitz' launch) to September 2002. For our judgmentally selected sample, we found that the average webfares decreased by $1.49 between 2001 ($149.14) and 2002 ($147.65).

Some of Orbitz' competitors provided data to demonstrate that the number of webfares being offered by the industry was declining and that this was the result of the MFN clause. We attempted to evaluate this issue but since 2001, many changes have occurred in the airline industry that have caused a variety of pricing, capacity, and marketing actions that have impacted consumers' access to airline fares. The events of September 11, 2001 and the economic pressures caused by reduced business travel have pressured airlines to fill more seats with discounted

[17]In some cases, more than one non-Charter Associate airline operated in the sample of the markets we tested. In those tests, we selected the non-Charter Associate airline that had the lowest fare and used that fare to calculate our lowest average fare.

fares. These same pressures have also caused airlines to reduce capacity, which has likely made fewer seats available at *all* fares, counteracting the discounting with a reduced seating inventory.

With the launch of Orbitz in June 2001, it is possible that the MFN clause has also impacted pricing and marketing strategies pursued by the airlines during the past year. However, with these events occurring simultaneously, it is difficult to conclusively pinpoint the drivers behind airline pricing and marketing actions, or to specifically link the availability and quality of webfares to Orbitz' MFN clause.

The Department Did Not Draw Conclusions Related to the Impact of the MFN on Competition

Because of the open investigation at the Department of Justice, the Department of Transportation refrained from drawing conclusions concerning the extent to which ties between the airline-owners and the MFN clause in the Charter Associate Agreements have resulted in monopolistic or other anticompetitive market behavior. The Department did, however, identify positive impacts that Orbitz has had on the ticket distribution market. Examples include Orbitz' unbiased display of airfares, development of search technology that enables consumers to see more fare options, Supplier Link technology, and GDS fee rebates to Charter Associates that will pressure other distribution outlets to lower their distribution costs.

The Department, however, raised concerns that the Orbitz MFN clause could discourage selective discounting and other direct marketing initiatives through various distribution channels. The concern was that Orbitz' airline-owners would attempt to protect their investment in Orbitz by withholding their best fares from Orbitz' competitors, even if the economic terms for distributing through those sites are the same or better than what Orbitz is offering. By withholding these fares from other distribution outlets, Orbitz' airline-owners could ensure that Orbitz maintains a competitive advantage. If Orbitz loses its competitive advantage, the value of the investment made by the airline-owners would likely diminish. The Department did not indicate that it found evidence of such problems. In our review, we found evidence that the owner-airlines were distributing their lowest fares through a variety of distribution channels. Our observations related to that issue are included in the following section.

Orbitz' Airline-Owners and Charter Associates Are Increasingly Providing Their Lowest Fares to Orbitz' Competitors

Both online and brick-and-mortar travel agencies have stated that access to webfares is critical for attracting and maintaining a customer base. Orbitz has contractually negotiated access to most of its Charter Associates' webfares through the MFN provisions of its Charter Associate agreement. Orbitz claims that no Charter Associates have provided it with exclusive fares—meaning that these fares would only be available on Orbitz. However, there have been many instances where Charter Associates have offered fares only on their own websites and on Orbitz. Orbitz' competitors have alleged that the MFN clause has both discouraged and prevented airlines from sharing their webfares with other agencies—both online and brick-and-mortar. They also alleged that when the airlines refuse to distribute webfares beyond Orbitz—even when the competing agencies offer equivalent economic terms—Orbitz gains a commanding marketplace advantage.

We reviewed data supplied to the Department, conducted interviews with industry stakeholders, and performed our own tests of online ticket distribution sources to determine what conclusions could be drawn about whether Orbitz' airline-owners and Charter Associate airlines were acting in an anticompetitive manner by refusing to distribute their lowest airfares to other online travel agencies.

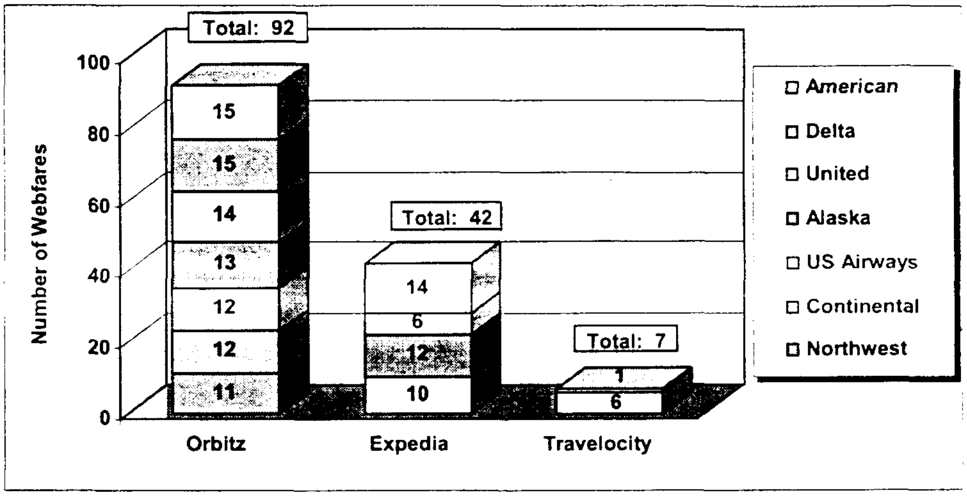
Our Tests Showed That Orbitz Had Advantageous Access to Webfares, But Recent Agreements Have Narrowed That Advantage

At any given time, the bulk of the fares that can be purchased online are the same fares that could be purchased through a brick-and-mortar travel agency or through the airlines' call centers. Only a small portion of fares are reserved as "web-only" fares that can be purchased only on the Internet. In many cases, the fares are heavily restricted and require the consumer to purchase and travel with only a few days notice. However, nearly all of the travel agencies have claimed that having access to this small inventory of webfares is essential to attracting consumers.

To determine which agencies were getting access to webfares, we designed a separate test that consisted of a judgmental sample of 108 deeply discounted webfares offered for travel over an approaching weekend. We tested between 12 and 15 webfares offered on eight airlines.

During our tests in August 2002, we found that all of the top three online travel agencies displayed at least some of the airlines' weekend webfares, although the degree of access varied significantly. Of the 108 webfares tested, Orbitz had access to 92 (85 percent), Expedia 42 (39 percent), and Travelocity 7 (6 percent) (see Figure 7).

Figure 7. Numbers of Weekend Webfares Displayed By Each of the Top Three Online Agencies (Out of a Total 108 Tested)*



* When we conducted our tests, America West's webfares did not appear on any third-party agency websites. They were available only on the airline's own website.

All of the airlines whose webfares we tested are Charter Associates and are bound by the MFN clause to provide all their webfares to Orbitz. Of the airlines we tested, all except one were abiding by that clause. America West had just become a Charter Associate when we conducted our tests and stated that it had miscoded its weekend webfares when filing them with ATPCo. We have since checked America West's weekend webfares and found that Orbitz is now able to access and display those fares.

In recent months, several deals have been finalized between the Charter Associates and Orbitz' competitors that will allow those agencies to access the airlines' publicly-available webfares. For example, in July 2002, Travelocity and American Airlines signed an 8-year contract that will give Travelocity access to American webfares in exchange for reduced distribution costs for all American fares and services sold on Travelocity. We have reviewed the terms of several of these agreements and their basic terms appear similar to those offered by Orbitz. The fact that the airlines are now sharing these fares with other online agencies would seem to refute the notion that the airline-owners are tacitly colluding to withhold them.

The online agencies believe that their terms are actually better than what Orbitz is offering, but that claim is difficult to evaluate. The agreements between the airlines and Orbitz' competitors include override provisions that can cause the economic terms to vary depending on whether the agency meets its sales targets. Because of the new agreements, we expect any future tests to show a distribution of webfares that closes the gap with Orbitz' offerings; thus, further eroding Orbitz' marketplace advantage.

Competitive Pressure From Orbitz Has Resulted in Price Concessions From Two GDSs

One Charter Associate, US Airways, recently became the first airline to allow brick-and-mortar travel agencies to access all publicly available webfares. By signing 3-year agreements with Sabre and Galileo, US Airways expects to reduce its GDS fees on all bookings in those systems by about 10 percent and freeze the fees for 3 years. In exchange, all travel agencies that subscribe to Sabre and Galileo will be able to access and sell US Airways' webfares.

When we testified before the Senate Commerce Committee in July 2000, we said that Orbitz could potentially benefit the marketplace by putting competitive pressure on GDSs to lower booking costs and improve services. We stated, "[i]f airlines are successful in drawing consumers to distribution channels that incur lower booking fees—such as Orbitz—the [GDSs] that provide services for the higher cost distribution channels will lose business. If the [GDSs] want to keep this business, reducing their fees would give airlines more of an incentive to provide them with their lowest fares." The fact that the recent agreements with Sabre and Galileo reflect an effort by the GDSs to compete with Orbitz and other distribution sources that have reduced their costs in response to Orbitz would seem to indicate that Orbitz has indeed brought about this positive market effect.

The Department Did Not Reach Conclusions On Whether Airlines Were Refusing to Share Their Lowest Fares With Orbitz' Competitors.

The Department did not reach a conclusion on whether airlines were refusing to provide their lowest fares to Orbitz' competitors even when the same economic terms were offered. The GDS costs and transaction fees are relatively simple to calculate, but the in-kind marketing promotion costs are more complicated.[18] Orbitz assigns values to certain kinds of promotions, such as in-flight movie spots or advertising in frequent flyer newsletters; but the cost to the airline to provide such promotion is considerably less. For example, Orbitz might credit an airline for hanging a banner in its terminal commensurate to the amount that the airline could charge another advertiser to use that space, but the cost incurred by the

[18] The Charter Associate Agreement also requires airlines to market Orbitz to their customers. The amount of advertising required is commensurate with sales of the airline's services on Orbitz. The credit for this "in-kind" marketing is valued at the rate another entity, like Orbitz, might pay for the marketing opportunity, and not the actual cost incurred by the airline to provide the marketing material.

airline for making this space available is inconsequential. Orbitz claims none of the Charter Associates are likely to reject paying customers in order to meet their marketing requirements on Orbitz.

The Department also identified the difficulty in quantifying other nontangible benefits that are of significant value in the Orbitz deal, including the value of an unbiased display, a long-term contract with declining airline transaction fees, and the potential for Supplier Link (which will eliminate the majority of GDS booking fees on bookings through Orbitz). Because Orbitz is contractually precluded from biasing its display, Orbitz cannot agree to override commissions. Orbitz' competitors, however, depend on agreements that are based on shifting market share as a means for obtaining override commissions. The economics of these agreements depend on whether or not those targets are met. When the Department was preparing its report, a number of those deals were in the midst of negotiations and the Department was not able to analyze the final terms of the agreements to determine whether they were comparable to Orbitz' economics. We have looked at excerpts of some of the final agreements, and in our opinion, they are comparable.

Finally, in its report, the Department did not reach conclusions as to whether it would be considered anticompetitive if the airlines did refuse to provide Orbitz' competitors access to their lowest fares when similar terms were offered. However, we note that the Department of Transportation Office of General Counsel (OGC) recently dismissed two complaints alleging that the airlines' distribution strategies were anticompetitive.[19] In dismissing the complaints, the OGC emphasized that longstanding public policy affirmatively allows each airline to decide what fares to charge, where to offer their goods for sale, and under what terms.[20] The opinion states, "[t]he antitrust laws generally allow firms to decide how to distribute their own goods and services, including whether and to what extent to do so directly or by agents. A carrier's unilateral decision to stop selling its services through travel agencies would thus violate no antitrust principle."

Planned Public Stock Offering Does Not Negate Need for Continued Departmental Oversight

Oversight bodies and industry stakeholders have voiced concerns about the intentions of Orbitz' airline-owners. The Department of Justice, the Department

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[19] On September 4, 2002, the OGC dismissed two complaints filed with Department of Transportation in October 1999 and March 2002 by the American Society of Travel Agents. The complaints alleged that the airlines and Orbitz, through its airline ownership, have reduced commissions and acted in such a way as to drive travel agents out of business or force them to institute fees for their services.

[20] Except to the extent that such practices constitute an unfair or deceptive practice or are judged to be a violation of the antitrust laws. Airlines with ownership interests in GDSs are also required to participate equally in competing GDSs.

of Transportation, and our office have reviewed Orbitz' plans prior to launching as well as its operations since that launch in June 2001. While no tangible harm has been proven to date, many industry observers remain skeptical.

Orbitz' airline-owners have maintained that a publicly-held company would introduce internal checks and balances that could mitigate external concerns about the airline-owners operating a joint venture. *We have reviewed the initial public offering and have concluded that the minority shareholders are likely to exert very little control over the general operations of the public company.* The structure of the company following the stock offering, in Orbitz' own words, provides the airline-owners with, "...a greater degree of control and influence in the operation of [the] business and the management of [company] affairs than is typically available to stockholders of a publicly-traded company."

When Orbitz goes public, the airline-owners will control six seats of the nine-seat board, and maintain the ability to nominate (and vote on) the remaining three seats. In addition, by giving themselves "supermajority" voting rights, the airline-owners state that they will be able, "to exercise control over all matters requiring approval by the board of directors or our stockholders. [...]." Although the airline-owners will assume a fiduciary responsibility to act in the best interest of the company rather than in ways that primarily benefit their respective airlines, pursuing a breach of fiduciary duties lawsuit through the courts is expensive and time-consuming, and often the legal standard used to evaluate management decision making allows a great amount of latitude.

According to the Securities and Exchange Commission, many family-owned businesses adopt a similar control structure in order to preserve parts of the business that are important to the family, but may possibly run contrary to shareholders' financial interests. In Orbitz' case, the airline-owners believe that maintaining substantial control of the company after it goes public is necessary to preserve Orbitz' commitment to unbiased fare and service displays and to act as a price competitor on distribution costs, which non-airline shareholders may not believe are in their own financial interest. If such is the case, however, it would be disingenuous for Orbitz to hold out the introduction of minority shareholders as a substitute for external monitoring.

Title 49, United States Code, Section 41712 gives the Department the authority to act to prevent airlines and agents from engaging in unfair methods of competition in air transportation and the sale of air transportation. More specifically, the authority allows the Department to prohibit unfair practices, deceptive practices, and competitive practices that (1) violate the antitrust laws, (2) violate antitrust principles, or (3) are likely to become antitrust violations if allowed to continue unchecked. The Department has an ongoing responsibility to monitor the behavior of all of the airlines to ensure they are not engaging in unfair methods of competition and as part of this general responsibility, should continue to observe how the airlines use all distribution outlets, including Orbitz, to distribute their services.

We provided the Office of the Assistant Secretary of Aviation and International Affairs with an advance copy of this report and have received and incorporated comments on our observations as appropriate.

We appreciate the courtesies and cooperation of representatives from the Department of Transportation, Office of the Assistant Secretary for Aviation and International Affairs, during this evaluation. If you have any questions concerning this report, please call me at (202) 366-1992 or Mark Dayton, Assistant Inspector General for Competition and Economic Analysis, at (202) 366-9970.

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EXHIBIT A. STATISTICAL SAMPLE METHODOLGY PLAN

TESTING METHODOLOGY

We independently designed two tests of online ticket distribution to provide us with additional data to help evaluate: (1) whether Orbitz' MFN clause has resulted in anticompetitive behavior by its airline-owners or whether the MFN clause has given Orbitz a significant marketplace advantage and (2) whether Orbitz' airline-owners are restricting the distribution of their webfares exclusively to Orbitz and their own websites.

We began Test 1 in the summer of 2002 by selecting a preliminary statistical sample of 110 airport-pairs from a universe of 3,027. We divided the 110 airport-pairs and tested 55 markets using itineraries with parameters typical of business travelers and 55 markets using itineraries with parameters typical of leisure travelers to determine how many times a website found or matched the lowest fare or price. In order to improve the precision of our results, we expanded our review in November 2002 to include another statistical sample of 251 airport-pairs. We performed two tests in each market—one with a business itinerary, and one with a leisure itinerary for a total of an additional 502 tests.

Airfare testing was limited to five online travel distribution channels—three major online travel agencies (Orbitz, Travelocity, and Expedia); Charter Associate airline websites; and non-Charter Associate airline websites including AirTran, Frontier, Southwest, JetBlue, and American Trans Air, and all other non-Charter Associate airlines operating in the airport pairs tested. Testing was conducted simultaneously on Orbitz, Travelocity, Expedia, and non-Charter Associate airline websites. The Charter Associate airline websites were tested after the lowest fare from each of the other four online distribution channels was found. Fares were noted including all taxes and fees, and any additional fees, such as consumer service fees, fees for paper tickets, etc. were noted. Analyses of results were conducted on a "fare-only" basis as well as a "fare+fee" basis to determine the actual cost of the product to consumers. Table 4 summarizes the parameters for the respective tests.

Table 4. Business and Leisure Itinerary Parameters

Parameters	Business	Leisure
Connections	Non-stop 1-Stop	Non-stop 1-Stop 2-Stop
Layover	3 hours	5 hours (each)
Travel Times	Depart: No earlier than 5:50 a.m. Arrive: No later than 12:10 a.m.	Any- overnight travel permitted
Restrictions	No Saturday stay	7-day, Saturday Stay
Advance Purchase	2-3 day	21 day

Auditors and analysts conducted a total of 540 tests which included 20 additional business and 20 additional leisure itineraries to replace tests that were later found to be invalid. Some reasons for the invalidated tests include itineraries selected that were outside the applicable parameters, failure to choose the lowest fare, and lack of supporting documentation of fare availability.

We found that our second sample verified the results of our first. We can be 90 percent confident that the margin of error of our estimates is no larger than 4.9 percent. Table 5 shows the detailed test results with the associated confidence limits and margins of error.

In Test 2, we selected a judgmental sample of 108 webfares offered for sale in August 2002 by eight Charter Associates, including the five founding airlines. We selected between 12 and 15 weekend webfares for the eight airlines that were being offered for travel for the approaching weekend. We simultaneously tested these itineraries on the three major online travel agencies to identify which online agencies had access to this fare inventory. We also simultaneously tested the offering airline's own website to ensure that an agency's inability to access a fare did not reflect a lack of availability.

We also compared a judgmental sample of 118 webfares offered in July 2001 to webfares offered in August and September 2002 to determine whether and to what extent average webfares have increased in those markets. The markets were judgmentally selected based on whether a webfare between the two markets was available in both 2001 and 2002.

Table 5 presents the confidence limits and margins of error for our final November 2002 test results.

Table 5. Confidence Limits for Simple Random Sample

	Lowest Fare Found or Matched	Best Estimate	90% Lower Confidence Limit	90% Upper Confidence Limit	Margin of Error
Number of Airport-Pairs in Universe			3,027		
Number of Airport-Pairs in Sample			251		
Confidence Level			90%		
Fare-Business					
Orbitz	181	72.1%	67.6%	76.6%	4.5%
Travelocity	158	62.9%	58.1%	67.8%	4.8%
Expedia	170	67.7%	63.1%	72.4%	4.7%
Non-Charter	47	18.7%	14.8%	22.6%	3.9%
Charter	182	72.5%	68.1%	77.0%	4.4%
Fare-Leisure					
Orbitz	199	79.3%	75.2%	83.3%	4.0%
Travelocity	138	55.0%	50.0%	59.9%	5.0%
Expedia	135	53.8%	48.8%	58.8%	5.0%
Non-Charter	34	13.5%	10.1%	17.0%	3.4%
Charter	163	64.9%	60.2%	69.7%	4.8%
Fare-Combined					
Orbitz		**76%**	71.4%	80.0%	4.3%
Travelocity		**59%**	54.1%	63.9%	4.9%
Expedia		**61%**	55.9%	65.6%	4.9%
Non-Charter		**16%**	12.5%	19.8%	3.7%
Charter		**69%**	64.1%	73.3%	4.6%
Price-Business					
Orbitz	8	3.2%	1.4%	4.9%	1.7%
Travelocity	164	65.3%	60.6%	70.1%	4.7%
Expedia	174	69.3%	64.7%	73.9%	4.6%
Non-Charter	47	18.7%	14.8%	22.6%	3.9%
Charter	185	73.7%	69.3%	78.1%	4.4%
Price-Leisure					
Orbitz	9	3.6%	1.7%	5.4%	1.9%
Travelocity	172	68.5%	63.9%	73.2%	4.6%
Expedia	171	68.1%	63.5%	72.8%	4.6%
Non-Charter	34	13.5%	10.1%	17.0%	3.4%
Charter	192	76.5%	72.3%	80.7%	4.2%
Price-Combined					
Orbitz		**3%**	1.6%	5.2%	1.8%
Travelocity		**67%**	62.2%	71.6%	4.7%
Expedia		**69%**	64.1%	73.3%	4.6%
Non-Charter		**16%**	12.5%	19.8%	3.7%
Charter		**75%**	70.8%	79.4%	4.3%

EXHIBIT B. ORBITZ' 42 CHARTER ASSOCIATE AIRLINES

Aeromexico
Air France
Air Jamaica
Air New Zealand
Alaska Airlines
Aloha Air
All Nippon Airways
America West Airlines
American Airlines
Asiana Airlines
Cathay Pacific Airways
China Airlines
Continental Airlines
COPA
CSA Czech
Delta Air Lines
El Al Israel
EVA Air
Finnair
Hawaiian Airlines
Iberia
Japan Airlines
KLM Royal Dutch
Korean Air
LanChile
LanPeru
LOT Polish
Lufthansa
Mexicana
Midwest Express Airlines
Northwest Airlines
Qantas
Scandinavian Airways
Singapore Airlines
South African Airways
Spirit Airlines
Swiss International Airlines
United Airlines
US Airways
Uzbekistan Airways
Varig
Virgin Atlantic Airways

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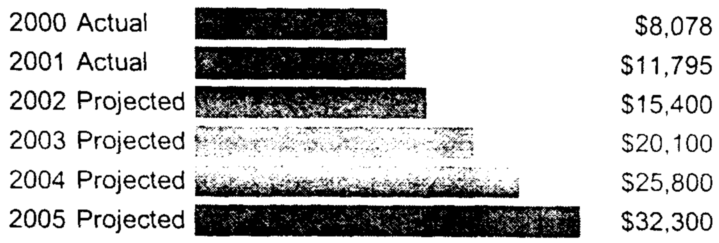
Main Document Charts and Tables

Note: The charts provided on the next two pages were not included in the original document, but have been provided here to allow screen readers access to the data that has been visually conveyed throughout this report.

Figure 1. Past and Projected Growth of Airline Tickets Sold Over the Internet, 2000 Through 2005



Source: PhoCusWright, May 2002

Figure 2. Average Monthly Air Market Share of Online Agencies, January Through September 2002

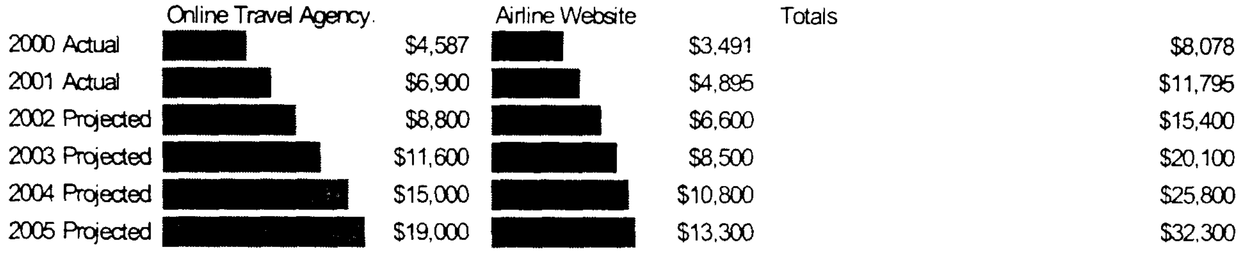
Online Travel Agency	January	February	March	April	May	June	July	August	September
Orbitz	25%	23%	24%	26%	25%	23%	23%	25%	24%
Travelocity	31%	33%	32%	32%	31%	31%	31%	30%	33%
Expedia	31%	32%	31%	29%	31%	33%	32%	32%	33%
Other	12%	13%	12%	14%	13%	13%	13%	14%	10%

Source: MIDT Data, January 2002 through September 2002

Figure 3. Per Ticket Distribution Costs for Two Major Carriers in 2000

Carrier	Airline Website	Reservation Agent	Online Travel Agency	Brick and Mortar Travel Agency
Airline 1	$6	$13	$20	$23
Airline 2	$15	$26	$36	$53

Figure 4. Airline Internet Ticket Sales, 2000 Through 2005



Source: PhoCusWright, May 2002

Main Document Charts and Tables

Figure 5. Travel Sales and Relative Share of Market for the Three Largest Online Travel Agencies, First Quarter 2002 ($ in millions)

	Travel Sales	Market Share
Orbitz	$542	22%
Travelocity	$783	32%
Expedia	$1,107	46%

Source: PhoCusWright Inc., May 2002

Figure 6. Average Monthly Air Market Share of Online Agencies, January Through September 2002

Online Travel Agency	January	February	March	April	May	June	July	August	September
Orbitz	25%	23%	24%	26%	25%	23%	23%	25%	24%
Travelocity	31%	33%	32%	32%	31%	31%	31%	30%	33%
Expedia	31%	32%	31%	29%	31%	33%	32%	32%	33%
Other	12%	13%	12%	14%	13%	13%	13%	14%	10%

Source: MIDT Data, January 2002 through September 2002

Figure 7. Numbers of Weekend Webfares Displayed By Each of the Top Three Online Agencies (Out of a Total 108 Tested)

Airline	Orbitz	Expedia	Travelocity
Alaska	13	12	0
American	15	14	1
Continental	12	0	0
Delta	15	0	0
Northwest	11	0	0
United	14	6	6
US Airways	12	10	0
Totals	**92**	**42**	**7**

Appendix D

NO. 67-194022-02

AMERICAN AIRLINES, INC., Plaintiff,	§	IN THE DISTRICT COURT OF
v.	§	
FARECHASE, INC., Defendant,	§	TARRANT COUNTY, TEXAS
SABRE INC., Intervenor.	§	67th JUDICIAL DISTRICT

INTERVENOR'S ORIGINAL COUNTERCLAIM

TO THE HONORABLE COURT:

Sabre Inc. ("Sabre"), Intervenor in this action, as Counter-Plaintiff, complains of Plaintiff American Airlines, Inc. ("American"), as Counter-Defendant, and for cause of action alleges the following by way of Counterclaim:

I. Incorporation of Allegations

Sabre adopts and incorporates by reference the allegations as set forth in its Plea in Intervention in this case.

II. Summary of Claims

Sabre's claims against American are simple. Sabre operates a computer reservation system (sometimes also referred to as a global distribution system or "GDS") that travel agents and others use to book air travel (among other things). American Airlines, like many other airlines, participates in this system. This participation allows American to distribute its services and sell its tickets to and through travel agents and others who subscribe to or use Sabre's computer reservation system (these people are commonly known in the industry as "subscribers").

The agreement between American and Sabre (referred to customarily in the industry as a "Participating Carrier Agreement" or "PCA") requires American to make all of its air fares available in Sabre's computer reservation system. American has refused and continues to refuse to make a class of fares known as "web fares" generally available to all of Sabre's subscribers. American's refusal to provide these fares for sale to any of Sabre's subscribers through the Sabre computer reservation system constitutes a breach of the PCA.

Sabre is seeking damages for past breaches and is asking the Court to require American to specifically perform its obligations in the future.

III. Facts

On about September 22, 1998, American entered into a written contract with the Sabre Group, Inc., entitled "Sabre Participating Carrier Distribution and Services Agreement." Thereafter, on about July 30, 1999, the Sabre Group, Inc., changed its name to Sabre Inc.

The PCA obligates Sabre to distribute American's services through the Sabre computer reservation system. Pursuant to the terms of that agreement, American (referred to in the PCA as the "Participating Carrier") agreed that it had the following responsibilities, among others set forth in the following enumerated provisions of the PCA:

> 2.1 Participating Carrier, at its own costs, shall coordinate its reservations services with SABRE to provide as advantageous and uniform reservations services to all SABRE Subscribers as it provides through any other GDS. In addition, any improvements, enhancements, or additional functions to Participating Carrier's reservations services offered to end users of any GDS will be offered by Participating Carrier to SABRE

Subscribers on the same terms and conditions as are agreed to with such GDS. Such services shall include, but are not limited to, ticketing capability, passenger information, interim schedule change data, fare data, fare quotations, and procedural information. Seat availability on each flight will be on a segment or first closing basis, and shall be in accordance with the provisions of Article III of this Agreement.

2.4 Participating Carrier will provide SABRE Group, as rapidly as possible, with all revisions to its information concerning services provided to passengers, including interim schedule change data, fare data and fare quotations, and such other material that may be included in SABRE. Participating Carrier will not close its flights to SABRE Subscribers on a less favorable basis than it uses to close flights to users of any GDS. Participating Carrier will transmit revisions immediately by AVS messages. Participating Carrier shall not withhold from SABRE Subscribers in any country any fare inventory class made available by Participating Carrier to users of any other GDS in that country.

2.16 SABRE Group shall use reasonable efforts to obtain the fares and fare rules which apply to Participating Carrier's flights from industry fare suppliers. If SABRE Group is unable to obtain such information after reasonable effort, Participating Carrier shall promptly supply, upon SABRE Group's request, the information to SABRE Group by loading in SABRE. Participating Carrier agrees to give SABRE thirty (30) days advance written notice of any changes in their fare vendor. The information shall be provided on magnetic tape or other medium mutually agreed upon by the parties. Any changes or revisions to such fares or fare rules shall thereafter be regularly submitted on a timely basis to SABRE Group by Participating Carrier by way of the same medium. Notwithstanding the foregoing, Participating Carrier shall submit such fare information on at least as timely and regular basis as is used for any other GDS. For fares and rules not submitted to SABRE through an industry fare supplier, Participating Carrier agrees that it will not issue a debit memo to a SABRE Subscriber for any SABRE auto-priced ticket wherein the debit memo is a result of a fare change about which Participating Carrier failed to notify SABRE Group at least ten (10) days prior to the effective date of that fare change.

American currently offers, and for some time in the past has offered, certain fares on its website, AA.com, which are commonly referred to as "web fares." These web fares are generally the lowest priced fares offered by American to the traveling public. As is evidenced by American's position in this lawsuit, American attempts to restrict access to those web fares except to visitors to the AA.com website, and others with whom American has entered into other commercial agreements with to obtain such web fares, such as Travelocity and Orbitz. Sabre is unable to obtain those web fares for the use of its subscribers from industry fare suppliers.

Although Sabre has requested that American provide its web fares to Sabre in a manner that Sabre can make those web fares available to its subscribers, American has refused to do so, and continues to refuse to do so. In failing and refusing to provide Sabre with the web fares, for use by Sabre and its subscribers, American is failing to perform its responsibilities and obligations pursuant to the terms of the PCA, including Sections 2.1, 2.4, and 2.16.

IV. Breach of Contract

Sabre has fully performed its obligations under the PCA. American has breached the terms of the PCA by wrongfully refusing to provide Sabre its web fares for use by Sabre and its subscribers.

V. Damages

As a result of American's breach of the PCA as set forth in the preceding paragraphs, Sabre has sustained financial harm and has lost some of the benefits to which it is entitled under the terms of the PCA.

VI. Specific Performance

Sabre has not repudiated the PCA and does not intend to do so. Sabre intends to continue to perform its obligations under the PCA. Therefore, Sabre seeks a decree from the Court requiring American to specifically perform its obligations under the PCA to provide Sabre access to American's web fares for use by Sabre's subscribers in the future.

VII. Conditions Precedent

All conditions precedent have been performed or occurred.

WHEREFORE, Sabre, as Counter-Plaintiff, requests judgment of the Court against American as Counter-Defendant as follows:

1. Damages in an amount within the jurisdictional limits of this Court.

2. A decree requiring American to specifically perform its obligations and responsibilities pursuant to the provisions of the PCA to provide Sabre access to American web fares for use by Sabre's subscribers.

3. Attorneys' fees.

4. Costs of suit.

5. Other and further relief to which the Counter-Plaintiff may be justly entitled.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that the foregoing Original Counterclaim was served by Certified Mail and facsimile transmission on counsel for American Airlines this 13th day of January, 2003. I certify that the foregoing was served on all other counsel of record by regular U. S. Mail and facsimile tranamission.

R. H. Wallace

R. H. Wallace, Jr.

Appendix E: Technical Corrections to the Proposed Text of Part 255

(i) The proposed definition of "participating carrier" in Part 255.3 includes an agreement for the "issuance of tickets through a system" as one of its conditions. If the Department adopts its proposal to delete a similar condition from the definition of "system," this condition also should be deleted from the definition of "participating carrier."

(ii) The proposed definition of "service enhancement" in Part 255.3 includes an agreement for the "issuance of tickets through a system" as one of its conditions. If the Department adopts its proposal to delete a similar condition from the definition of "system," this condition also should be deleted from the definition of "service enhancement."

(iii) The proposed definition of "system" in Part 255.3 includes the charging "to any other carrier a fee for system services" as one of its conditions. If the Department adopts its proposal to delete carrier ownership as a condition of the definition of "system," this clause of the definition simply should refer to the charging "to any carrier a fee for system services."

(iv) The proposed part 255.4(c)(7) would require CRSs to limit the disclosure of code-share services in the displays offered to subscribers. If the Department adopts its proposal, a conforming amendment should be adopted to Part 256.4, which requires CRSs not to deny access to or discriminate against code-share services.

(v) The proposed Part 255.8(d) includes a typographical error ("susbcriber").

(vi) The proposed Part 255.10 exempts air carriers that "fail[] to pay a non-discriminatory fee" from the anti-bias rule (Part 255.4). If the Department's proposal to delete the rule prohibiting discriminatory booking fees is adopted, this exemption also should be deleted.

(vii) The proposed Part 399.84(b) would establish a new policy for the disclosure of service fees by agents. The Department should consider instead making this an amendment to Part 399.80, which sets forth other policies for disclosures by ticket agents.

In addition, Orbitz suggests that the Department not, as proposed in the NPRM, renumber the subparts of Part 255 on account of the repeal of the mandatory participation rule, but instead reserve subpart 255.7 and retain the numbering of subsequent subparts. By retaining the current numbering system, the Department would reduce the risk of confusion in future discussions of and citations to Part 255.

CERTIFICATE OF SERVICE

I hereby certify that on this 17th day of March 2003, a copy of the foregoing Comments of Orbitz, Inc. was served by first class mail, postage prepaid, or by hand, on the following.

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